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CLOSE CORPORATIONS—INABILITY TO COMPEL ATTENDANCE AT A SHAREHOLDERS' MEETING BY MEANS OF AN INJUNCTION

Hall v. Hall[1]

Edward and Harry Hall were fifty percent shareholders and the only directors of Musselman and Hall Contractors, Inc., a Missouri corporation. On Edward's death, his widow, Margaret Hall, succeeded to a fifty percent stock interest in the corporation. Harry Hall, as the surviving director, appointed his wife, Florence, to replace Edward as a director of the corporation.[2] Thereafter, acting as the board of directors, Harry and Florence elected themselves president and vice-president.[3] They continued as directors and officers of the corporation; no further elections were held.

Upon the directors' failure to call the required annual meeting[4] of the corporation, Margaret Hall called an annual meeting[5] to be held on the date specified in the bylaws. In order to make the majority needed to make a quorum, both fifty percent shareholders had to attend the meeting.[6] Harry Hall refused to attend. Therefore, no election of new directors was possible, and Margaret adjourned the annual meeting from week to week.

The failure to hold a meeting and to elect new directors left Harry in practical control of the corporation. The directors passed a resolution to sell all authorized but unissued stock. Margaret Hall objected[7] to this resolution contending the stock issue was approved by directors unlawfully holding office. Margaret brought suit to en-

1. 506 S.W.2d 42 (Mo. App., D.K.C. 1974).
2. § 351.320, RSMo 1969, provides:
   In the case of the death or resignation of one or more of the directors of a corporation, a majority of the survivors or remaining directors may fill the vacancy or vacancies until the successor or successors are elected at a stockholders meeting.
3. § 351.360, RSMo 1969.
4. § 351.225, RSMo 1969.
5. *Id.*
6. § 351.265, RSMo 1969.
7. The director's action was one of a variety of techniques frequently employed to "squeeze out" minority shareholders. In the usual situation, shareholder-directors with effective control cause the corporation to issue a large number of new shares at a time when minority shareholders with preemptive rights are not in a position to finance the acquisition of their part of the issue. The effect of the new issue, therefore, is to dilute those minority shareholders' relative interests in the corporation. For other common types of squeeze-out techniques, see F. O'NEAL, CLOSE CORPORATIONS § 8.07 (1971).

join Harry from refusing to attend the shareholders' meetings, to enjoin the directors from establishing a terminal date for the exercise of preemptive rights, and to enjoin the directors from continuing to act as directors and officers pending a meeting of the shareholders.[8] The trial court dismissed the petition for failure to state a cause of action. The court of appeals affirmed.[9]

A close corporation, such as the one involved in *Hall*, can result from any of a number of business situations. Members of a partnership may decide to incorporate in order to obtain limited liability or some type of tax advantage.[10] The nature of the association between the participants, however, often remains unchanged, the participants viewing the assumption of corporate form as a mere formality. *Hall* makes it clear that such a belief is unfounded and that the corporate form has inherent dangers not associated with a partnership.

The Uniform Partnership Act[11] allows a partnership to fashion the type of management and organizational structure best suited to its needs. Furthermore, a statutory fiduciary duty exists between partners.[12] If this relationship is breached or if the partners disagree, a partner is free to withdraw and thereby dissolve the partnership.[13] Once incorporated, however, much of the flexibility in determining organization and control of the enterprise is lost as a result of the statutory and judicial concept of the "corporate norm."

The leading case espousing the doctrine of "corporate norm" is *Jackson v. Hooper*.[14] Two stockholders, owning all the stock of a corporation and desiring to retain joint control in themselves, agreed that three of the named directors would be dummy directors. Jackson then broke the agreement and combined with the dummy directors to deprive Hooper of control. The court held that the agreement was void as against public policy, stating:

> The law never contemplated that persons engaged in business as partners may incorporate, with intent to obtain the advantages and immunities of a corporate form, and then, Proteus-like, be-

8. 506 S.W.2d at 45.
9. *Id.*
10. *See* F. O'NEAL, note 7 *supra* at § 1.08.
11. Enacted in Missouri as Ch. 358, RSMo 1969. *See* § 358.180, RSMo 1969, which provides that a partner's rights and duties as set out in the statute are subject to a contrary agreement between the parties.
12. § 358.210, RSMo 1969.
13. § 358.310, RSMo 1969.
14. 76 N.J. Eq. 592, 75 A. 568 (Ct. Err. & App. 1910).

> come at will a copartnership or a corporation . . . . They cannot be partners *inter sese* and a corporation as to the rest of the world.[15]

Missouri judicial decisions and the dicta contained therein indicate that the courts have favored a strict application of the *Jackson* doctrine.[16] Recent statutory changes demonstrate, on the other hand, that the legislature is more ready to recognize the distinctive needs of the close corporation.[17] *Hall* gave the court an opportunity to alter its treatment of close corporations, and to reject the heretofore rigid adherence to the *Jackson* doctrine.

The court narrowed the controversy to one issue: Could a shareholder be compelled to attend stockholders' meetings if his failure to attend would prevent the presence of a quorum? In reaching its decision, the court relied on language found in section 351.275, RSMo 1969, which states that a shareholder "shall be under no obligation to the corporation other than to pay to the corporation the full consideration for which said shares were issued." A right to participate in the management of the corporation accompanies the ownership of the shares of stock,[18] and the court in *Hall* found that this also carries with it an equal right not to participate. In upholding Harry Hall's right to abstain, the court realized that by its decision Margaret Hall is denied her acknowledged right to participate. According to the court, this result follows from the distinction between the "corporate existence" and the "identity of the shareholders."[19]

However, it is questionable whether the statute[20] relied on by the court in *Hall* necessitates the decision reached. The section's primary purpose is to grant limited liability to a holder of stock. This limited liability is nevertheless subject to a court's power to "pierce the corporate veil."[21] Missouri courts have recognized their

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15. *Id.* at 599, 75 A. at 571.

16. Santa Fe Hills Golf & Country Club v. Safehi Realty Co., 349 S.W.2d 27, 34 (Mo. 1961); Leggett v. Missouri State Life Ins. Co., 342 S.W.2d 833, 851 (Mo. En Banc 1960); Taylor v. Baldwin, 362 Mo. 1224, 1245, 247 S.W.2d 741, 753 (En Banc 1952).

17. Typical of such changes are § 351.050, RSMo 1969 (allowing a single incorporator); § 351.315, RSMo 1969 (allowing a single director); and §§ 351.265, .325, RSMo 1969 (allowing the articles of incorporation to specify the number of shareholders and directors required to make a quorum over and above a simple majority). *See* Buchanan, *Missouri Corporation Statutes—Needed Changes For Close Corporations*, 38 Mo. L. REV. 460 (1973).

18. Insurance Agency Co. v. Blossom, 231 S.W. 636, 638 (St. L. Mo. App. 1921).

19. 506 S.W.2d at 45.

20. § 351.275, RSMo 1969.

21. *See* Z. CAVITCH, BUSINESS ORGANIZATIONS § 120.05 (1974). "[*A*] *court will disregard corporate personality whenever the same is asserted for a purpose inconsistent with the policy of the law in maintaining the concept.*" *Id.* at § 120.05[1].

ability to disregard the separate legal identities of a corporation and its shareholders in order to protect parties outside the corporation.[22] Some states have extended the use of this equitable power to matters involving disputes among the shareholders themselves.[23] *Hall* indicates that Missouri courts will not go so far, and will strictly apply the doctrine of *Jackson v. Hooper*[24] when dealing with intra-corporate conflicts.

The court premised its argument on the assumption that Harry Hall is under no legal duty to participate in the corporation. Harry Hall was, however, in complete control of the corporation and by his inaction as a shareholder was trying to insure that he would retain that complete control. The court sensed the injustice that may accompany the result, but stated that it is bound by "established rules and precedents" and is not free to act "merely upon its own conceptions of what may be right in a particular case."[25] The injunctions sought were therefore denied. The court did suggest other possible remedies available to Margaret Hall, which include bringing an action to force dissolution of the corporation, trying by quo warranto[26] the respondents' right to continue as officers and directors,

22. May Dep't. Stores Co. v. Union Elect. Light & Power Co., 107 S.W.2d 41, 55 (Mo. 1937). *See* Lynn v. Lloyd A. Lynn Inc., 493 S.W.2d 363, 367 (Mo. App., D. St. L. 1973); Smith v. City of Lee's Summit, 450 S.W.2d 485, 489 (Mo. App., D.K.C. 1972) (indicating that use of a corporation's separate legal entity as a subterfuge to defeat public convenience, to perpetrate a fraud, or as means to justify a wrong, will allow a court to grant relief to outsiders); *cf.* Butler v. Butler, 379 S.W.2d 175, 178 (St. L. Mo. App. 1964).

23. *See, e.g.*, Galler v. Galler, 32 Ill.2d 16, 203 N.E.2d 577 (1965).

> . . . [C]ourts have long ago quite realistically, we feel, relaxed their attitudes concerning statutory compliance when dealing with close corporation behavior, permitting "slight deviations" from corporate "norms" in order to give legal efficacy to common business practice.

Id. at 29, 203 N.E.2d at 584.

24. *See* note 14 and accompanying text *supra*.

25. 506 S.W.2d at 45; Possien v. Higgins, 421 S.W.2d 327, 331 (Mo. 1967). *But see* Weaver v. Jordan, 362 S.W.2d 66 (Spr. Mo. App. 1962).

> Equity is reluctant to permit a wrong to be suffered without remedy. It seeks to do justice and is not bound by strict common law rules or the absence of precedents. It looks to the substance rather than the form and will not sanction an unconscionable result merely because it may have been brought about by means which simulate legality. And once rightfully possessed of a case it will not relinquish it short of doing complete justice.

362 S.W.2d at 75.

26. Section 531.010, RSMo 1969, provides that if "any person shall usurp, intrude into or unlawfully hold or execute any office or franchise," the attorney general or any prosecuting attorney may, at the relation of any person, bring a quo warranto action in a circuit court. Section 531.050, RSMo 1969, provides that once an officer is adjudged guilty of any such usurpation, intrusion or unlawful holding, the court may oust such person from the office. An office in a private corporation, created and chartered by the state, is deemed to be of a public character, so that the public has a sufficient interest therein to render the remedy of

and certain "alternative methods" which were not enumerated.[27]

In a partnership, the holder of a minority interest can use his power to compel liquidation[28] as a weapon against actions contrary to his interest.[29] If Margaret Hall had possessed such a power she could have enforced her right to participate without judicial aid. However, Missouri's corporation statutes provide for voluntary dissolution only if all of the shareholders agree to it,[30] or upon resolution by the board of directors and concurrence of two-thirds of the shareholders.[31] Section 351.485, RSMo 1969, gives a shareholder the right to seek involuntary dissolution. However, absent a director deadlock, the shareholder must show that "the acts of the directors or those in control of the corporation are illegal, oppressive, or fraudulent" or that "the corporate assets are being misapplied or wasted."[32] The statute provides that even in the absence of fraud, if the director's conduct can be characterized as oppressive, dissolution may be ordered. Recent Illinois cases indicate that a court of equity has greater discretion in allowing dissolution in the case of oppression by a director[33] than in the case of fraud.

It should be noted, however, that the model act from which section 351.485, RSMo 1969, is taken expressly provided for dissolu-

quo warranto available against a corporate official. 74 C.J.S. *Quo Warranto* § 9 (1951). In State *ex inf.* Taylor v. Cumpton, 362 Mo. 199, 240 S.W.2d 877 (En Banc 1951), the court stated that willful failure and refusal by a county treasurer to perform statutory duties was sufficient to result in forfeiture of office. Conceivably, Mrs. Hall could bring a quo warranto action against both directors on the basis of their willful refusal to call the annual shareholders meeting required by statute. § 351.225, RSMo 1969. Though the remedy may be theoretically available, quo warranto does not offer dependable relief to persons in the position of Mrs. Hall, since directors could always avoid its reach by carefully complying with statutory duties. There would be no technical breach of duty if the directors called a meeting and shareholders refused to attend, even though the directors were also the recalcitrant shareholders.

27. 506 S.W.2d at 45.

28. § 358.310, RSMo 1969.

29. *See* Buchanan, note 17 *supra* at 471.

30. § 351.460, RSMo 1969.

31. § 351.465, RSMo 1969.

32. § 351.485, RSMo 1969. This section also allows for dissolution upon the corporation's application, suit by a creditor in certain cases, action by the attorney general, or forfeiture or revocation of the certificate of incorporation.

33. Gidwitz v. Lanzit Cor. Box Co., 20 Ill.2d 208, 170 N.E.2d 131 (1960). In *Gidwitz*, an Illinois court allowed dissolution under facts similar to *Hall* by characterizing as oppressive the corporate president's use of his position to control and manage the corporation without majority stock support, which effectively denied the other stockholders' rights and privileges. *See also* Central Std. Life Ins. Co. v. Davis, 10 Ill.2d 566, 141 N.E.2d 45 (1957), which held that the term "oppressive" does not necessarily savor of fraud, and that absence of mismanagement or misapplication of assets does not prevent a finding that the conduct of the directors or those in control of the corporation is oppressive.

tion in a case like *Hall*.[34] Missouri's failure to adopt such a provision may indicate that the legislature intended to require more than shareholder deadlock to justify dissolution. By that interpretation Mrs. Hall would be denied dissolution until the situation within the corporation worsened.

Thus, *Hall* stands as a warning to prospective shareholders and their attorneys contemplating the formation of a close corporation. Contingencies and intracorporate disputes such as those involved in *Hall* must be anticipated and planned for through mutually consistent charter, bylaws, and shareholder agreements. Missouri courts will not intervene with case-by-case exceptions in such controversies, but will strictly apply the corporation laws of the state to close corporations in the same manner as to any large, publicly-held concern.

This inflexible approach has been criticized by some writers who believe that the only way to insure adequate protection for minority shareholders is through judicial recognition of the distinctive nature of the close corporation.[35] It may well be, however, that a policy of judicial restraint, rather than interference, will ultimately offer the greater measure of protection to shareholders. The current Missouri policy does assure a predictable treatment of shareholder disputes when submitted to the courts for resolution. In the absence of a relevant enforceable agreement by which the parties have contracted for particular rights and remedies, no relief will be available unless specifically authorized by statute. If the statutory provisions do not satisfy the potential needs of a corporation or its shareholders, then the desired alternatives must be spelled out and all the necessary parties bound by them.[36] If special treatment

34. MODEL BUS. CORP. ACT 2d ANN. § 97 (1971) gives a court the power to liquidate the assets and business of a corporation when it can be shown that:

> The shareholders are deadlocked in voting power, and have failed, for a period which includes at least two consecutive annual meeting dates, to elect successors to directors whose terms have expired or would have expired upon the election of their successors.

35. *See, e.g.*, Comment, *Freezing Out Minority Shareholders Through the Issuance of Additional Shares*, 2 MEMPHIS ST. U.L. REV. 375, 388 (1972).

36. *See* Z. CAVITCH, note 21 *supra* at § 186.03, in which the author discusses several methods by which shareholders may provide for situations in which opposing factions frustrate corporate action: incorporating buy-out provisions in the charter or by-laws; the use of irrevocable proxies; issuance of non-voting classes of stock; and providing for a voting trust. *See also* O'Neal, *Giving Shareholders Power to Veto Corporate Decisions: Use of Special Charter and By-law Provisions*, 18 LAW & CONT. PROB. 451 (1953).

for *all* minority shareholders or for *all* close corporations is needed, the legislature, not the courts, will have to furnish it.[37]

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37. *See, e.g.*, DEL. CODE ANN. Tit. 8, § 223 (1973), which allows shareholders owning ten percent or more of the shares to petition the appropriate court for an order compelling a shareholder election to fill vacancies on the board of directors where the remaining directors do not constitute a quorum.

CONSTITUTIONAL LAW—ABRIDGMENT OF THE TWENTY-SIXTH AMENDMENT

Walgren v. Howes[1]

The Board of Selectmen for the Town of Amherst had, since 1939, set the annual town election for the third week of February. According to state law,[2] it was necessary to hold a special caucus at least 31 days before the town election. This special caucus, in the nature of a non-partisan primary election, was required whenever twice as many candidates as the number to be elected filed nomination papers. Absentee ballots were available. The special caucus was to take place in mid-January at which time most students residing on campus at the University of Massachusetts were required by the University to vacate their residences during semester recess.[3] Walgren, as a candidate for the office of selectman, was concerned about the youth and student vote and attempted to persudade the Board of Selectmen to rearrange the election schedule to encourage maximum voting in the college community by providing that the special caucus as well as the general election be held when the colleges were in session. The Board, however, voted to adhere to its initial plans to hold the special caucus during the semester recess.

Walgren, Glusco and Sherman (a full-time student at the University residing in one of its dormitories), brought suit as voters to prevent the holding of the local elections as planned, contending that the Board's action violated the first, fourteenth, and twenty-sixth amendments to the United States Constitution. The district court denied temporary relief and granted defendants' motion for summary judgment and dismissed for failure to state a claim.[4] The court of appeals reversed and remanded, holding that the plaintiff's petition alleging violations of the fourteenth and twenty-sixth amendments stated a claim.[5] The court held that the Board of Selectmen's conduct may have abridged the twenty-sixth amendment rights of a large group of 18 to 21 year-old voters in Amherst.[6] The court's language also suggests that the twenty-sixth amendment makes 18 to 21 year-old voters a protected group or "suspect class"

1. 482 F.2d 95 (1st Cir. 1973).

2. Caucus Act, ch. 149, Mass. Acts and Resolves of 1955, *as amended* ch. 54, Mass. Acts and Resolves of 1963.

3. 482 F.2d at 97.

4. *Id.* at 98.

5. *Id.* at 99. The court also held that the district court had erred in granting summary judgment because material issues of fact did exist. *Id.* at 98.

6. *Id.* at 102.

whose right to vote may not be disproportionately abridged under the fourteenth amendment unless the abridgment is necessary to achieve some compelling governmental objective.[7] Therefore the court remanded for determination of: (1) whether the election date placed such a burden upon the student's voting rights as to constitute an abridgement of their rights; and (2) the adequacy of governmental justification.[8]

The Supreme Court in a series of cases has held that certain fundamental rights are entitled to special protection under the Equal Protection Clause of the fourteenth amendment.[9] For example, in holding that the conditioning of the right to vote on the payment of a poll tax is unconstitutional, the Court stated that "once the franchise is granted the electorate, lines may not be drawn which are inconsistent with the Equal Protection Clause of the Fourteenth Amendment."[10] The Court also noted that where fundamental rights (such as voting) are asserted under the Equal Protection Clause, any classifications which might invade or restrain them must be closely scrutinized and carefully confined.[11] Accordingly, if a right is deemed to be a fundamental constitutional right the state may not infringe upon that right without carrying the heavy burden of showing an "overwhelming" or "compelling" state interest. The right to vote has been held by the Supreme Court to be such a fundamental constitutional right.[12]

7. *Id.* at 99-100. The court also considered the plaintiff's equal protection claim that the Board of Selectman's scheduling discriminated against all voters who could not be present in Amherst on the date of the caucus. Relying on Rosario v. Rockefeller, 410 U.S. 752 (1973), the court held that the compelling interest test did not apply because there was no total denial of the absent voter's electoral franchise (absentee ballots were available). The court stated that the plaintiffs would have a heavy burden of proof on this particular claim.

8. *Id.* at 102.

9. *See e.g.*, Weber v. Aetna Cas. & Surety Co., 406 U.S. 164 (1972)(illegitimates).

10. Harper v. Board of Elections, 383 U.S. 663, 665 (1969).

11. *Id.* at 670. In Dunn v. Blumstein, 405 U.S. 330 (1972), the Court, in striking down a one year residency requirement for voting, pointed out that there exists within the Equal Protection Clause a category of constitutionally protected rights which the state may not infringe upon without a compelling state interest. 405 U.S. at 342. *See also* Evans v. Cornman, 398 U.S. 419 (1970) (law disenfranching residents of National Institute of Health held unconstitutional).

12. As early as 1886 the United States Supreme Court characterized the right to vote as a "fundamental political right, because [it is] preservative of all rights." Yick Wo v. Hopkins, 118 U.S. 356 (1886). The Court, in dealing with the problem of apportionment, said "the right to vote freely for the candidate of one's choice is of the essence of a democratic society." Reynolds v. Sims, 377 U.S. 533, 555 (1964). In Kramer v. Union Free School Dist. No. 15, 395 U.S. 621 (1969), the Court held that a New York education law, which provided that only owners of taxable real estate within the school district or parents or guardians of pupils enrolled in district schools could vote in school district elections, violated the four-

This constitutionally protected right to vote was extended to an estimated eleven million[13] individuals when the twenty-sixth amendment to the United States Constitution became effective in 1971.[14] The amendment, based on similar language in the fifteenth, nineteenth and twenty-fourth amendments, provides that the right of citizens eighteen years or older to vote shall not be denied or abridged on account of age. It has been said that the word "abridged" in the twenty-sixth amendment means to diminish, re-

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teenth amendment and stated that the franchise constitutes the foundation of our representative society. *See also*, Cipriano v. Houma, 395 U.S. 701 (1969). An Arizona law limiting the vote in a general obligation bond election to only real property owners was declared unconstitutional because the Court could find no compelling state interest to justify depriving non-property owners of their right to vote in such an election. Phoenix v. Kolodziejski, 399 U.S. 204 (1970). Also, in Evans v. Cornman, 398 U.S. 419 (1970), the Court said that before the right to vote can be restricted the restriction must meet close constitutional scrutiny. Finally, after surveying prior cases in the voting rights area, the Court flatly stated, "In decision after decision, this Court has made clear that a citizen has a constitutionally protected right to participate in elections on an equal basis with other citizens in the jurisdiction." Dunn v. Blumstein, 405 U.S. 330, 336 (1972). *Cf.* Salyer Land Co. v. Tulare Lake Basin Water Storage Dist., 410 U.S. 719 (1973), where the Supreme Court upheld an election in which only landowners could vote and the number of votes was apportioned according to assessed valuation of the land. The Court noted, however, that the case did not involve a unit of local government exercising general governmental power, as did prior voting rights cases. In Rosario v. Rockefeller, 410 U.S. 752 (1973), the Court upheld a statute requiring voters to register for primary elections eight months in advance on the grounds that there was a valid state interest and voters were able to comply with the statute.

13. Comment, *The College Voter and Residency Requirements*, 17 S.D.L. REV. 131 (1972).

14. The twenty-sixth amendment provides:

> Section 1. The right of citizens of the United States, who are eighteen years of age or older, to vote shall not be denied or abridged by the United States or by any State on account of age. Section 2. The Congress shall have the power to enforce this article by appropriate legislation.

U.S. CONST. amend. XXVI.

The movement to extend the right to vote had gained momentum in the 1960's when mass disturbances on campus sparked interest in constructively channeling this youthful idealism into the political system through the exercise of the right to vote. 1 *U.S. Code Cong. & Ad. News* 937 (1971). Congress, in the Voting Rights Act of 1970, attempted by legislation to extend the franchise to 18-year-olds in all elections, either state or federal. 42 U.S.C. § 1973 bb-1 (1970). The Supreme Court, however, held that although Congress had the power to lower the voting age in federal elections, it lacked the power to lower the voting age in state elections. Oregon v. Mitchell, 400 U.S. 112 (1970). The nation was thus faced with an administrative nightmare of providing two separate electoral systems. 1 *U.S. Code Cong. & Ad. News* 941-47 (1971). In response to all of these forces, Congress passed (Senate-March 10, 1971; House-March 23, 1971), and the necessary two-thirds of the states ratified, the twenty-sixth amendment to the United States Constitution. (Alabama, Alaska, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Missouri, Montana, Nebraska, New Hampshire, New Jersey, New York, North Carolina, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, Tennessee, Texas, Vermont, Washington, West Virginia, and Wisconsin).

duce, curtail, or deprive.[15] Thus, the amendment was to serve a two-fold purpose: (1) prohibit complete denial of the right to vote to young people; and (2) prevent any undue burdens on the exercise of this right to vote.[16] According to the court in *Walgren*, setting of an inconvenient election date may be an undue burden on the right of young people to vote, and therefore violative of the fourteenth and twenty-sixth amendments.[17]

Although any election date will inconvenience some individuals in the community, the date would not ordinarily be subject to constitutional attack because the group of inconvenienced voters would be relatively small in number, and would include a cross-section of the eligible voters. The date for the special caucus in *Walgren*, however, disproportionately burdened one large (some 30 percent of the electorate in Amherst) constitutionally protected group of voters because it was held on a date when the members of that group were required by university policy to vacate their residences.[18] The city, under state law,[19] had the option of rescheduling the election at a time when these voters would be present.[20] Under such circumstances, an election day which deprives or burdens 18 to 21 year-olds of the right to vote may be discrimination which is prohibited by the twenty-sixth and fourteenth amendments.[21]

Two state courts have recently struck down attempts to prevent students from registering and voting in their college communities as violations of the fourteenth and twenty-sixth amendments. In *Wilkins v. Bentley*,[22] the Supreme Court of Michigan stated that it was not necessary for students to demonstrate an absolute denial of the right to vote in order to require the state to show a compelling interest for the action. The students were only required to show that

15. Jolicoeur v. Mihaly, 5 Cal. 3d 565, 571, 488 P.2d 1, 4, 96 Cal. Rptr. 697, 700 (1971).

16. Wilkins v. Bentley, 385 Mich. 670, 189 N.W.2d 423 (1971); Worden v. Board of Elections, 61 N.J. 325, 294 A.2d 233 (1972).

17. Walgren v. Howes, 482 F.2d 95, 102 (1st Cir. 1973).

18. *Id.* at 95.

19. Caucus Act, ch. 149, Mass. Acts and Resolves of 1955, *as amended* ch. 54, Acts of 1963.

20. *See* notes 31-35 and accompanying text *infra*.

21. The general admonitory teaching of Lane v. Wilson, 307 U.S. 268 (1939), a case brought under the fifteenth amendment, seems most relevant. "The [fifteenth] amendment nullifies sophisticated as well as simple-minded modes of discrimination. It hits onerous procedural requirements which effectively handicap exercise of the franchise . . . ." 307 U.S. at 275. So too should the twenty-sixth amendment strike down subtle discrimination in the choice of an election day which will force youthful voters to vote by the more cumbersome absentee method as well as the outright denial of their right to vote.

22. 385 Mich. 670, 189 N.W.2d 423 (1971).

a burden had been placed on their right to vote.[23] Likewise, the New Jersey Supreme Court in *Worden v. Board of Elections*[24] stated that the purpose of the twenty-sixth amendment was not only to extend voting rights to 18 to 21 year-olds, but also to encourage their participation by the elimination of all unnecessary barriers and burdens.[25] The New Jersey court noted that the Senate Report considering the Voting Rights Act of 1970 pointed out that it was inconsistent with the purpose of the Voting Rights Act to force young voters to undertake special burdens, such as absentee ballots, because this would dissuade them from participating in the election.[26]

In addition, the United States Supreme Court in *Gomillion v. Lightfoot*[27] indicated that a law, though not discriminatory on its face, is invalid if its substantive effect is to discriminate against a constitutionally protected group. In *Gomillion*, a city had changed its boundaries from a rectangular shape to a 28-sided configuration. Although this action was neutral on its face, the effect of the boundary change was to "fence out" most blacks from the city, and therefore deprive them of the right to participate in city elections.[28] By analogy, the setting of the special caucus election on a date when most student voters would be required to vacate their residences, though not discriminatory on its face, would discourage most student voters from participating in the city's electoral process. Such an election date, facially neutral but having the effect of burdening the rights of young people to vote, would certainly fit within the *Gomillion* rationale and could be held violative of the twenty-sixth amendment.

Finally, since the special caucus in *Walgren* was similar to a primary election (the "special caucus" was held whenever more than twice as many candidates filed for office as the number to be elected and was designed to limit the number of candidates who could run for office in the regular town election), the Supreme Court's decision in *Bullock v. Carter*[29] must be considered. In *Bullock*, the Court held that a Texas primary election filing fee system violated the Equal Protection Clause because its unreasonably high filing fees limited a voter's choice of candidates by denying

23. *Id.* at 684, 189 N.W.2d at 429.
24. 61 N.J. 325, 294 A.2d 233 (1972).
25. *Id.* at 333, 294 A.2d at 237.
26. *Id.*
27. 364 U.S. 339 (1960).
28. *Id.* at 347.
29. 405 U.S. 134 (1972).

some candidates the chance to file for election.[30] Similarly, if the 18 to 21 year-olds' right to vote is burdened in a primary election, their choice of candidates in the general election might be limited and they would thereby be denied the opportunity to vote for a candidate of their own choosing.

In dealing with the specific facts of *Walgren*, the question arises as to whether there existed a class of individuals within the protection of the twenty-sixth amendment who were entitled to raise the issue of age discrimination. The scheduling of the caucus election during the semester recess of area colleges did not burden the right to vote of all young voters, but rather only those young voters who lived in the college's dormitories and would be forced to vacate their residences during the semester break. The setting of any election date could be said to discriminate against voters absent on election day, not merely young voters, and thus the twenty-sixth amendment, since it applies only to age discrimination, would be inapplicable. Such an argument is, however, clearly not appropriate in light of the facts in the *Walgren* case. Due to the date of the special caucus election, 30 percent of the eligible voters of Amherst would be absent on the date of the caucus, the vast majority of the absentees being young college students clearly within the protection of the twenty-sixth amendment. The exclusion of these voters from the special caucus election arguably limits the choice of candidates for whom these college students could vote in the general election. *Walgren* would seem to be analogous to *Gomillion v. Lightfoot*[31] in that just as the boundary change in *Gomillion* did not disenfranchise all blacks, the election date in *Walgren* did not burden the right to vote of all young voters. However, in each case, the voting rights of a constitutionally protected group were disproportionately affected. Therefore, the members of the group were a proper class to assert the constitutional protections of voting rights amendments.

Even if the governmental unit can show reasons why an election should be held on a date when it would place a burden on young voters, the election date will usually nonetheless be unconstitutional under the fourteenth and twenty-sixth amendment because a reasonable alternative date will typically exist which would not disproportionally burden the young voters' right to vote. In *Shelton v. Tucker*[32] the Court stated:

30. *Id.* at 149.
31. 364 U.S. 339 (1960).
32. 364 U.S. 479 (1960).

> [E]ven if the government purpose be substantial and legitimate, that purpose cannot be pursued by means that broadly stifle fundamental personal liberties when the end can be more narrowly achieved. The breadth of the legislative abridgement must be viewed in the light of less drastic means for achieving the same basic purpose.[33]

The Court in a recent voting rights case, *Dunn v. Blumstein*,[34] echoed the same concept, stating that it was not sufficient for the state merely to show a very substantial interest. In pursuit of its interest, the state cannot choose means which unnecessarily burden or restrict a constitutionally protected activity and, if there are other reasonable ways to achieve the state's goal with a lesser burden on constitutionally protected activities, then the state may not choose the way of greater interference.[35] The Michigan Supreme Court, in an action challenging the constitutionality of a voter registration statute, also recognized that the state has the burden of demonstrating that the particular regulation is necessary and essential and not achievable by less drastic means.[36] In *Walgren*, less drastic measures were available to the city since state law required only that the caucus election be held at least 31 days before the general election.[37] It was possible for this requirement to be met while holding the special caucus election at a time other than during the semester recess.

The twenty-sixth amendment, by extending the franchise to eleven million voters between the ages of eighteen and twenty-one, not only guaranteed them the right to vote but also provided that the right shall not be unduly burdened. The twenty-sixth amendment, like the fifteenth amendment, was designed to strike down the sophisticated as well as simple-minded discrimination against the protected group. The setting of an election date at a time when it would burden young persons' right to vote would seem to be just such a forbidden discrimination. The amendment will not affect

33. *Id.* at 488. *See also*, Dean Milk Co. v. Madison, 340 U.S. 349, 354-56 (1951), for a similar statement involving the commerce clause.

34. 405 U.S. 330 (1972).

35. *Id.* at 343.

36. Michigan State U.A.W. Community Action Program Council v. Austin, 387 Mich. 506, 517, 198 N.W.2d 385, 389 (1972). In Shapiro v. Thompson, 394 U.S. 618 (1969), a case involving the right to travel, the United States Supreme Court invalidated a Pennsylvania welfare law requiring applicants to have resided in the state one year prior to receiving any benefits. The Court noted that less drastic means were available to accomplish the state goal of limiting payments to qualified recipients.

37. Caucus Act, ch. 149, Mass. Acts and Resolves of 1955, as amended by ch. 54, Mass. Acts and Resolves of 1963.

national, state, and local elections in which the 18 to 21 year-old voters are not disproportionately burdened compared to other segments of the electorate. Such elections are valid because a cross-section of the electorate rather than one particular group's right to vote is inconvenienced and thus the election date could not be said to constitute unfair treatment of any one group. However, if a so-called college town is involved, the twenty-sixth amendment may require that the municipality not schedule elections during a recess in the school year if the following factors are met: 1) college students constitute a substantial portion of the eligible voters in the town; 2) the setting of the election date during a school vacation period would disproportionately burden the voting rights of the college-age voters; 3) the date on which the election is to be held is within the discretion of the city; and 4) there are reasonable alternative dates for the election. If these factors are present, any election held during a time when students are required to vacate their residences should be closely scrutinized to determine if a compelling state interest exists for holding the election on such a date.

Clearly the passage of a constitutional amendment creates serious problems of accomodation.[38] Yet, if the twenty-sixth amendment's purpose of encouraging youthful participation in the electoral process is to be achieved, adjustments must be made in the elective system to facilitate the exercise of the right to vote by these newly franchised voters.

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38. Walgren v. Howes, 482 F.2d 95, 102 (1973).

CONSTITUTIONAL LAW—EQUAL PROTECTION—DISENFRANCHISEMENT OF EX-FELONS: THE STANDARD OF REVIEW

Richardson v. Ramirez[1]

Plaintiffs, three ex-felons who had completed their sentences and paroles, sought a writ of mandamus in the California Supreme Court to compel the clerks of their respective counties to register them to vote in the 1972 elections. The California constitution[2] and statutes[3] disenfranchise persons convicted of certain crimes whose sentences and paroles have expired. Plaintiffs contended that these provisions denied them the equal protection of the laws under the fourteenth amendment. Relying on several recent United States Supreme Court decisions on voter qualifications,[4] plaintiffs argued that California had to show a compelling state interest in order to justify the exclusion of the class of ex-felons from the franchise. The California Supreme Court found that the provisions violated fourteenth amendment equal protection.[5] The United States Supreme

1. ___ U.S. ___, 94 S.Ct. 2655 (1974).

2. At the time the action was instituted, the relevant constitutional provisions were CAL. CONST. art. II, § 1, which provided:

> [N]o person convicted of any infamous crime, no person hereafter convicted of the embezzlement or misappropriation of public money . . . shall ever exercise the privileges of an elector in this State. . . .

and CAL. CONST. art. XX, § 11, which provided:

> Laws shall be made to exclude from office, serving on juries, and from the right of suffrage, persons convicted of bribery, perjury, forgery, malfeasance in office, or other high crimes.

In November, 1972, the quoted portion of article II was deleted, and the following language was added as new article II, § 3:

> The Legislature shall prohibit imporper practices that affect elections and shall provide that no . . . person convicted of an infamous crime, nor person convicted of embezzlement or misappropriation of public money, shall exercise the privileges of an elector in this state.

The California Supreme Court held that the passage of this new article did not render the case moot because the standard for disenfranchisement of ex-felons remained unchanged. Ramirez v. Brown, 9 Cal. 3d 199, 204-05, 107 Cal. Rptr. 137, 139-40, 507 P.2d 1345, 1347-48 (1973), *rev'd sub nom.*, Richardson v. Ramirez, ___ U.S. ___, 94 S.Ct. 2655 (1974).

3. The implementing statutes are CAL. ELECTIONS CODE §§ 310, 321, 383, 389, 390, 14240, 14246 (West 1961).

4. Dunn v. Blumstein, 405 U.S. 330 (1972); Bullock v. Carter, 405 U.S. 134 (1972); Kramer v. Union Free School Dist., 395 U.S. 621 (1969); Cipriano v. City of Houma, 395 U.S. 701 (1969).

5. Ramirez v. Brown, 9 Cal. 3d 199, 216-17, 107 Cal. Rptr. 137, 149, 507 P.2d 1345, 1357 (1973), *rev'd sub nom.*, Richardson v. Ramirez, ___ U.S. ___, 94 S.Ct. 2655 (1974). The named plaintiffs were voluntarily registered prior to the judgment. As a consequence, the California Supreme Court denied them relief. The court, nevertheless, ruled on the constitutional claim to provide guidance to other election officials faced with the same problem. This circumstance, combined with other unusual procedural features of the case, led a majority

Court reversed.[6]

The United States Supreme Court relied on section 2 of the fourteenth amendment. Section 2 provides for a reduction in a state's congressional representation when it denies or in any way abridges the right to vote for state or federal officers, except that a state may exclude from the vote without penalty persons guilty of "participation in rebellion, or other crime."[7] From an examination of the legislative history of the fourteenth amendment, subsequent Reconstruction legislation, and state practices, the majority concluded that the language of this exception "was intended by Congress to mean what it says."[8] Since the framers explicitly recognized in section 2 of the amendment a state's power to exclude from voting persons convicted of crimes, the Court reasoned that the equal protection clause of section 1 could not "prohibit outright" this form of disenfranchisement.[9] Two dissenting justices in *Richardson* implied that the decision approved a blanket disenfranchisement of ex-felons "insulate[d] . . . from equal protection scrutiny."[10] An analysis of the majority opinion shows its holding to be considerably more limited.

The usual procedure in equal protection cases is to determine the applicable standard of judicial review and to measure against that standard the particular classification being challenged. The Court selects from a "spectrum of standards"[11] an appropriate one

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of the United States Supreme Court to conclude that the action was not moot because it was, in effect, a declaratory judgment in a class action. Richardson v. Ramirez, ___ U.S. at ___, 94 S.Ct. at 2664 (1974).

6. ___ U.S. ___, ___, 94 S.Ct. 2655, 2671-72 (1974).

7. U.S. CONST. amend. XIV, § 2 reads in full:

> Representatives shall be apportioned among the several States according to their respective numbers, counting the whole number of persons in each State, excluding Indians not taxes. But when the right to vote at any election for the choice of electors for President and Vice President of the United States, Representatives in Congress, the Executive and Judicial officers of a State, or the members of the Legislature thereof, is denied to any of the male inhabitants of such State, being twenty-one years of age, and citizens of the United States, or in any way abridged, *except for participation in rebellion, or other crime*, the basis of representation therein shall be reduced in the proportion which the number of such male citizens shall bear to the whole number of male citizens twenty-one years of age in such State. (emphasis added).

8. ___ U.S. ___, ___, 94 S. Ct. 2655, 2665-66 (1974).

9. *Id.* at ___, 94 S.Ct. at 2671.

10. *Id.* at ___, 94 S.Ct. at 2682. Justice Marshall, writing for the dissent, argued that § 2 "was not intended and should not be construed to be a limitation on the other sections of the Fourteenth Amendment." *Id.* at ___, 94 S.Ct. at 2680.

11. The phrase is Justice Marshall's. San Antonio Ind. School Dist. v. Rodriguez, 411 U.S. 1, 98 (1973) (Marshall, J., dissenting). *Accord*, Vlandis v. Kline, 412 U.S. 441, 458 (1973) (White, J., concurring).

depending on the "constitutional and societal importance of the interest adversely affected and the recognized invidiousness of the basis upon which the particular classification is drawn . . . ."[12] The initial step can be crucial because, as a practical matter, under some tests distinctions rarely fail and under others they cannot succeed.

In a line of cases stretching back over a decade,[13] the Supreme Court has treated the right to vote as a "fundamental matter."[14] The Court has repeatedly affirmed that "to exercise the franchise in a free and unimpaired manner is preservative of other basic civil and political rights . . . ."[15] Although it has expressly stated that the Constitution does not confer the right to vote on any one,[16] the high court has said that "a citizen has a *constiutionally protected right* to participate in elections on an equal basis with other citizens in the jurisdiction." (emphasis added)[17] Consequently, any selective distribution of the franchise must be subject to "careful examination" and "close scrutiny."[18] Absent special circumstances which dictate that a lesser standard is proper,[19] the legality of a classification which gives the vote to some and withholds it from others is to be judged by whether "the exclusions are necessary to promote a compelling state interest."[20]

Richardson holds this standard inapplicable to state laws disenfranchising ex-felons because the language of the Constitution itself as interpreted by the courts, indicates their right to vote is not entitled to the same standard of constitutional protection afforded the franchise generally.[21] The case, however, does not specify what standard of review is to be used. Its holding is confined to the "proposition that § 1, in dealing with voting rights as it does, could not have been meant to bar outright" the exclusion of former felons from the vote.[22] The majority did not say that section 2 permitted

12. San Antonio Ind. School Dist. v. Rodriguez, 411 U.S. 1, 99 (1973) (Marshall, J., dissenting).

13. *See, e.g.*, cases cited note 4 *supra* and note 14 *infra.*

14. Reynolds v. Sims, 377 U.S. 533, 562 (1964).

15. *Id. See also* Dunn v. Blumstein, 405 U.S. 330, 336 (1972).

16. Minor v. Happersett, 88 U.S. (21 Wall.) 162, 178 (1874).

17. Dunn v. Blumstein, 405 U.S. 330, 336 (1972).

18. Kramer v. Union Free School Dist., 395 U.S. 621, 626 (1969).

19. *Id.* at 632. Salyer Land Co. v. Tulare Lake Basin Water Storage Dist., 410 U.S. 719 (1973) and Associated Enterprises Inc. v. Toltec Watershed Improvement Dist., 410 U.S. 743 (1973), found such exceptions relying on language in Avery v. Midland County, 390 U.S. 474 (1968), and Hadley v. Junior College Dist. 397 U.S. 50 (1970).

20. Kramer v. Union Free School Dist., 395 U.S. 621, 627 (1969).

21. ___ U.S. ___, ___, 94 S.Ct. 2655, 2671.

22. *Id.* at ___, 94 S.Ct. at 2671.

such exclusions "outright," Section 2 was not used as the standard itself against which to measure the classification. It only provided guidance to the interpretation of the equal protection clause in this matter.[23] States may continue to consider prior convictions in establishing voter qualifications,[24] but they still must comport with some form of equal protection standards. *Richardson* makes no attempt to measure the permissibility of the basis California has chosen for excluding ex-felons from the vote. The Court implicitly approved the disenfranchisement of ex-felons in some form, but it left unexplained what limitations, if any, are to be placed on such state action.[25] *Richardson* provides a partial answer to the threshold problem of equal protection; it does not address the substance. *Richardson* left few clues as to what standard of review is applicable.[26] The possibilities fall into two general categories.

The Supreme Court has applied a relatively low standard of review in equal protection challenges to state economic regulations. Under this "economic" equal protection test, a statute is valid if there is "any state of facts [which] reasonably may be conceived to justify" the classifications made.[27] The extensive discretion afforded to legislative line-drawing in this area is illustrated by the fact that under this test the Court has struck down only one state law.[28]

In two recent voter qualification decisions where the Court, as it did in *Richardson*, retreated from the compelling state interest test, the economic equal protection standard was applied.[29] However, these cases are clearly distinguishable from the disenfranchisement of ex-felons. Both involved limited purpose elections whose effect would fall disproportionately on a particular group of voters.[30]

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23. *Id.* at ___, 94 S.Ct. at 2671.

24. Lassiter v. Northampton County Bd. of Elections, 360 U.S. 45, 51 (1959).

25. Prior to the decision it was hoped *Richardson* would provide a definitive review of the problem. Note, *The Need for Reform of Ex-Felon Disenfranchisement Laws*, 83 YALE L.J. 580 (1974).

26. *See* cases cited note 36 *infra*.

27. McGowan v. Maryland, 366 U.S. 420, 426 (1961).

28. Morey v. Doud, 354 U.S. 457 (1957). One situation which may justify the invalidating of state laws excluding some ex-felons, even under this minimal test, is suggested by Stephens v. Yeomans, 327 F. Supp. 1182 (D.N.J. 1970). In that case, the United States District Court held a New Jersey statute violative of equal protection because of the haphazard development of the laws disenfranchising ex-felons. Their "curious history" led to incongruous results. For example, embezzlers and attempted murderers could vote, but those persons convicted of larceny and murder could not. Many other equally serious crimes were not covered by the disqualification. *Id.* at 1188.

29. Salyer Land Co. v. Tulare Lake Basin Water Storage Dist., 410 U.S. 719, 732 (1973); Associated Enterprises Inc. v. Toltec Watershed Improvement Dist., 410 U.S. 743, 745 (1973).

30. Salyer Land Co. v. Tulare Lake Basin Water Storage Dist., 410 U.S. 719, 728 (1973);

In addition, even those voters disqualified in these special elections could indirectly affect the subject matter through the general elections.[31] In disenfranchisement, however, the exclusion of former felons is total. They have no alternative method of asserting their interests through the election process.

Considering the importance the Court attaches to the franchise generally,[32] it seems unlikely that it will virtually abdicate its judgment in these matters to that of the legislature—even where the persons affected are ex-felons. While their right to vote does not receive the same level of constitutional protection due to a constitutional quirk,[33] an ex-felon's access to the polls is no less fundamental to him than it is to any other citizen.[34] Following this notion, the appropriate standard of review should be the "reasonable" rational basis. Under this test, not every conceivable rational basis will justify a classification. The rational basis must also be reasonable. The Court has applied this test in previous voter qualification cases.[35] The decision in *Richardson* does not foreclose use of the test and indeed the precedent cited by the majority suggests it may be proper.[36]

Associated Enterprises Inc. v. Toltec Watershed Improvement Dist., 410 U.S. 743, 745 (1973).

31. *Cf.* Kramer v. Union Free School Dist., 395 U.S. 621, 640 (1969) (Stewart, J., dissenting):

> The appellant is eligible to vote in all state, local, and federal elections in which general governmental policy is determined. He is fully able, therefore, to participate . . . in the processes by which the requirements for school district voting may be changed . . . . He clearly is not locked into any self-perpetuating status of exclusion from the electoral process.

32. *See* text accompanying notes 13-20 *supra*.

33. Even the majority in *Richardson* cannot explain why the words "other crime" were tacked on the amendment, ___ U.S. ___, 94 S.Ct. 2655, 2666-68. The historical record on this point is, as Justice Marshall says, "unilluminating at best." *Id.* at ___, 94 S.Ct. at 2680.

34. *Id.* at ___, 94 S.Ct. at 2683 (Marshall, J., dissenting).

35. Carrington v. Rash, 380 U.S. 89 (1965). In *Carrington*, the Court struck down a Texas law prohibiting servicemen who entered the state while in the military from voting as long as they remained in the service. It was recognized the state had the power "to impose reasonable residence restrictions on the availability of the ballot," but these steps went too far. *Id.* at 91. The Court did not apply the "any conceivable" rational basis test since it rejected a "conceivable" basis offered by Justice Harlan in the dissent. *Id.* at 99-101 (Harlan, J., dissenting). Subsequent cases have often cited *Carrington* as an application of the compelling state interest test. *See, e.g.*, Kramer v. Union Free School Dist., 395 U.S. 621, 627 (1969). However, Justice Blackmun was correct in noting that these later cases have significantly elevated the standard of review used in *Carrington*. Dunn v. Blumstein, 405 U.S. 330, 362 (1972) (Blackmun, J., concurring). Certainly the author of the opinion thought *Carrington* applied the reasonable rational basis test. Harper v. Virginia State Bd. of Elections, 383 U.S. 663, 683 (1966) (Harlan with Stewart, JJ., dissenting).

36. Lassiter v. Northampton County Bd. of Elections, 360 U.S. 45 (1959) (previous criminal record, along with age, residency, and literacy are factors which states may consider in setting voter qualifications designed to promote intelligent use of the ballot); David v.

Under the "reasonable" rational basis some laws disqualifying former felons are likely to fall. The California practice is an intermediate position which would probably survive.[37] The California courts have interpreted their constitution to disfranchise a person for conviction of a crime only where the offense is "such that he who has committed it may reasonably be deemed to constitute a threat to the integrity of the elective process."[38] Whether such an exclusion is truly effective or wise is debatable.[39] but one can certainly defend as reasonable basing the disability on the nature of the crime rather than the nature of the punishment.[40]

Missouri statutory provisions, on the other hand, take a broader position. The general disqualification statute denies the franchise to "any person convicted of a felony"[41] without qualification as to the type of crime.[42] Unlike California, Missouri also specifies chapter by chapter in the feolony statutes, that conviction of each of the offenses contained therein excludes a person from the vote.[43] The irrelevance of the nature of the crime is illustrated by the fact that Missouri courts have held a person disenfranchised for a crime that was

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Beason, 133 U.S. 333 (1890) (person disenfrancised because still in the prohibited criminal status); Green v. Board of Elections, 380 F.2d 445 (2d Cir. 1967), *cert. denied*, 389 U.S. 1048 (1968) (court pointed to reasonable justifications for disenfranchising ex-felons). *See also* Trop v. Dulles, 356 U.S. 86, 96-97 (1958) (dictum that laws disenfranchising persons for conviction of crime were nonpenal because they designate "a reasonable ground of eligibility for voting"). The actual "reasonableness" of many of the classifications in these cases may be questionable. ___ U.S. ___, ___, 94 S.Ct. 2655, 2684-86 (1974) (Marshall, J., dissenting); Otsuka v. Hite, 64 Cal. 2d 596, 605-06, 414 P. 2d 413, 418-19, 51 Cal. Rptr. 284, 290-91 (1966); Note, *The Need for Reform of Ex-felon Disenfranchisement Laws*, 83 YALE L.J. 580, 581 & n.9 (1974). Nevertheless, that is the standard against which they were measured.

37. Note, *The Need for Reform of Ex-felon Disenfranchisement Laws*, 83 YALE L.J. 580, 582-84 (1974).

38. Otsuka v. Hite, 64 Cal. 2d 596, 611, 414 P.2d 412, 422, 51 Cal. Rptr. 284, 294 (1966). The court did not specifically indicate what crimes fell into this category, but left the determination to local election officials.

39. *See, e.g.*, 14 U.C.L.A. L. REV. 699 (1967). In practice, application of the rule has varied widely from county to county because of a lack of more definite standards. Richardson v. Ramirez, ___ U.S. at ___, 94 S.Ct. at 2661 n. 12. The Supreme Court remanded the case for consideration whether this lack of uniformity in enforcement was a separate denial of equal protection. *Id.* at ___, 94 S.Ct. at 2671-72.

40. Otsuka v. Hite, 64 Cal. 2d 596, 611, 414 P.2d 412, 422, 51 Cal. Rptr. 284, 294 (1966).

41. § 111.021, RSMo 1969. The person is excluded forever after a second conviction of any felony. First offenders suffer only a limited disenfranchisement. § 216.355, RSMo 1969.

42. In addition to felonies, misdemeanors "connected with the exercise of the right of suffrage" disenfranchise a person in Missouri. Like felonies, a second conviction attaches the disability forever in absence of a pardon. § 111.021, RSMo 1969.

43. §§ 129.420 (corrupt practices and election offenses), 557.490 (perjury), 558.130 (offenses related to official duties), 559.470 (offenses against the person), 560.610 (offenses against property), 561.340 (offenses against property involving fraud), 564.710 (offenses against public health and safety), RSMo 1969.

a felony in the jurisdiction where convicted but only a misdemeanor in Missouri.[44] With few exceptions,[45] Felony convictions are disqualifying across the board. If the purpose of these laws is to protect the purity of the ballot box,[46] then it is doubtful the state could reasonably justify some of the exclusions.[47]

The disenfranchisement of ex-felons may still prove to have a constitutional limit. Nevertheless, Justice Rehnquist in *Richardson* advises that the problem is more amenable to a legislative solution.[48] The unpredictability of the Supreme Court is well known, and how it may rule on a particular classification is a matter of speculation. Therefore, those who support the lifting of state restrictions on the exercise of the franchise by former felons may find a more responsive forum in the legislature. Extending the franchise to ex-felons is a policy matter,[49] and many states have done so to one extent or another.[50] There is no constitutional bar, state[51] or federal,[52] to such action by the Missouri General Assembly.

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44. State *ex rel.* Barrett v. Sartorious, 351 Mo. 1237, 175 S.W.2d 787 (En banc 1943); Bruno v. Murdock, 406 S.W.2d 294 (K.C. Mo. App. 1966).

45. §§ 111.021 (pardons), 216.355 (first offenders two years after completion of sentence), 549.111 (completion of judicial parole), 560.610 (person under twenty years of age at time offense committed), RSMo 1969.

46. "The true purpose of such a disqualification is now generally conceded to be not merely additional punishment of the individual but to safeguard and preserve the purity of elections." State *ex rel.* Barrett v. Sartorious, 351 Mo. 1237, 1241, 175 S.W.2d 787, 788 (En banc 1943).

47. For example, there seems to be little relation between a person's conviction for stealing of domestic fowl in the nighttime and the possible threat he poses to the integrity of the election process. § 560.610, RSMo 1969. *See* Otsuka v. Hite, 64 Cal. 2d 596, 605, 414 P.2d 412, 418, 51 Cal. Rptr. 284, 290 (1966).

48. ___ U.S. ___, ___, 94 S.Ct. 2655, 2671.

49. *Id.* at ___, 94 S.Ct. at 2686 (Marshall, J., dissenting). *See generally*, Note, *Restoring the Ex-offender's Right to Vote: Background and Developments*, 11 AM. CRIM. L. REV. 721 (1973).

50. ___ U.S. ___, ___, 94 S.Ct. 2655, 2685 n.28 (Marshall, J., dissenting). A bill has been introduced in the House of Representatives which would restore voting rights in federal elections to ex-offenders, H.R. 14594, 93rd Cong., 2d Sess. (1974). It was unanimously reported by a subcommittee to the full House Judiciary Committee on August 21, 1974. The bill would not pre-empt state voting rights laws. 2 CRIMINAL JUSTICE 10 (No. 3, Fall 1974).

51. Mo. CONST. art. VIII, § 2 provides:

> No . . . person . . . while confined in any public prison shall be entitled to vote, and persons convicted of felony, or crime connected with the exercise of the right of suffrage *may be excluded* by law from voting. (emphasis added).

The Missouri Supreme Court has interpreted this clause as vesting "wide discretion in the legislature to determine the extent to which persons convicted of a felony may be excluded from the suffrage." State *ex rel.* Oliver v. Hunt, 247 S.W.2d 969, 973 (Mo. En Banc 1952).

52. ___ U.S. ___, ___, 94 S. Ct. 2655, 2671.

CONSTITUTIONAL LAW—TAX EXEMPT STATUS AS "STATE ACTION"

Jackson v. Statler Foundation[1]

Rev. Donald Jackson brought suit against thirteen private charitable foundations, alleging that the foundations refused to hire him as a director of their foundations, refused to give scholarships to his children, and refused to grant money to his foundation, all for reasons of race. Rev. Jackson sought injunctive and declaratory relief, damages, revocation of the foundations' tax exempt status under the Internal Revenue Code, and an order directing the foundations to surrender all their assets to the United States Treasury.[2] On motion of the defendant foundations, the district court dismissed the complaint.[3] The district judge held that insofar as appellant based his claims on 42 U.S.C. § 1983,[4] the requisite "state action" was lacking.

In a 3-0 decision, the U.S. Court of Appeals reversed in part the district court's ruling.[5] The decision of the Second Circuit hinged on its belief that state action may be found from the fact that the foundations enjoyed tax exempt status. Judge Friendly, joined by three other circuit judges, filed a vigorous dissent to the circuit's denial of his request to reconsider the case en banc.[6] The dissent found the logic of the panel to be uncompelling and characterized the decision as "the most ill-advised decision with respect to 'state action' yet rendered by any court. . . ."[7]

Some background is essential when wading into "the murky waters of the 'state action' doctrine."[8] The Equal Protection Clause

1. 496 F.2d 623 (2d Cir. 1974).

2. *Id.* at 625. Rev. Jackson appeared before the court *pro se*. This fact caused a great deal of confusion in ascertaining exactly what was claimed. The Second Circuit construed the contentions of Rev. Jackson most generously. *See, e.g.*, Haines v. Kerner, 404 U.S. 519 (1972).

3. The decision of the district court is unreported.

4. 42 U.S.C. § 1983 (1970). *See* statute quoted at note 10 *infra*.

5. 496 F.2d 623 (2d Cir. 1974).

6. *Id.* at 636. The history of the *Jackson* opinion merits discussion. The *Jackson* panel at first thought an affirmative answer to the question of state action resulting from tax exempt status was so obvious as to deserve only a single paragraph of a *per curiam* opinion. Thereafter, Judge Friendly requested that the case be reconsidered *en banc*. After several judges had voted in favor of reconsideration, the panel requested that a final vote be deferred pending circulation of the new revised opinion. Despite the vote of half of the active judges of the second circuit in favor of an *en banc* hearing of the case, reconsideration was denied for lack of a majority vote. Judge- Hays, Feinberg and Mulligan joined with Judge Friendly in supporting reconsideration.

7. 496 F.2d at 637 (Friendly, J., dissenting).

8. McGlotten v. Connally, 338 F. Supp. 448, 455 (D.D.C. 1972).

of the fourteenth amendment[9] and Section 1983[10] apply only where a state has deprived a person of his constitutional rights.[11] Discriminatory conduct by a state is subject to constitutional prohibitions, whereas the Equal Protection Clause "erects no shield"[12] against truly private discrimination "however discriminatory or wrongful."[13] It is clear, however, that "[c]onduct that is formally 'private' may become so entwined with governmental policies or so impregnated with a governmental character as to become subject to the constitutional limitations placed upon state action."[14]

It is significant that minimal state involvement is insufficient to trigger constitutional restrictions. Governmental involvement in private conduct does not rise to the requisite level of state action unless the state has "significantly involved itself"[15] in the alleged deprivation. In *Burton v. Wilmington Parking Authority*,[16] the Supreme Court said that the Equal Protection Clause applies to private action in situations where the state has "so far insinuated itself into a position of interdependence . . . that it must be recgonized

9. U.S. CONST. amend. XIV, § 1 states:

All persons born or naturalized in the United States, and subject to the jurisdiction thereof, are citizens of the United States and of the State wherein they reside. No State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws.

10. 42 U.S.C. § 1983 (1970) states:

Every person who, under color of any statute, ordinance, regulation, custom, or usage of any State or Territory, subjects, or causes to be subjected, any citizen of the United States or other person within the jurisdiction thereof to the deprivation of any rights, privileges, or immunities secured by the Constitution and laws, shall be liable to the party injured in an action at law, suit in equity, or other proper proceeding for redress.

11. Civil Rights Cases, 109 U.S. 3 (1883).

12. Shelley v. Kraemer, 334 U.S. 1, 13 (1948).

13. *Id.*

14. Evans v. Newton, 382 U.S. 296, 299 (1966).

15. *See e.g.*, Moose Lodge No. 107 v. Irvis, 407 U.S. 163 (1972); Reitman v. Mulkey, 387 U.S. 369 (1967). Of late it has been frequently suggested that dual standards exist in determining whether state action is present. A less rigorous standard is said to be used where an allegation of racial discrimination is present. *See, e.g.*, Norwood v. Harrison, 413 U.S. 455 (1973); Grafton v. Brooklyn Law School, 478 F.2d 1137 (2d Cir. 1973); Lefcourt v. Legal Aid Soc'y, 445 F.2d 1150, 1155, n.6 (2d Cir. 1971); Powe v. Miles, 407 F.2d 73, 81 (2d Cir. 1968); Bright v. Isenbarger, 314 F. Supp. 1382, 1390 (N.D. Ind. 1970); Pitts v. Dep't of Rev., 333 F. Supp. 662, 668 (E.D. Wis. 1971). At page 1142 of *Grafton* the court states:

. . . while a grant or other index of state involvement may be impermissible when it "fosters or encourages" discrimination on the basis of race, the same limited involvement may not rise to the level of "state action" when the action in question is alleged to affront other constitutional rights.

16. 365 U.S. 715 (1961).

as a joint participant in the challenged activity. . . ."[17] Thus, state action which is not "significant" is insufficient to bring private conduct within the purview of constitituional sanctions.

The predecessor of *Jackson* was *McGlotten v. Connally*.[18] *McGlotten* was a suit to enjoin officials of the Treasury Department from granting tax exemptions and deductions to fraternal organizations which excluded nonwhites from membership. The three-judge court held that the exemptions granted from income and the allowance of deductions from contributions to these organizations constituted sufficient governmental involvement to require the organizations to act within consititutional limits. In so holding, the *McGlotten* court focused on the fact that sections 170[19] and 502[20] of the Internal Revenue Code expressly chose fraternal organizations for tax relief.[21] In the words of the *McGlotten* court:

> By providing differential treatment to only selected organizations, the Government has indicated approval of organizations and hence their discriminatory practice, and aided that discrimination by the provision of federal tax benefits.[22]

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17. *Id.* at 725.

18. 338 F. Supp. 448 (D.D.C. 1972) (three-judge court). For a severe criticism of *McGlotten*, see Bittke & Kaufman, *Taxes and Civil Rights: "Constitutionalizing" the Internal Revenue Code*, 82 YALE L.J. 51 (1972). *See also*, Note, *The Internal Revenue Code and Racial Discrimination*, 72 COLUM. L. REV. 1215 (1972); Comment, *Tax Incentives As State Action*, 122 U. PA. L. REV. 414 (1973); Note, *Granting of Tax Benefits to Discriminatory Fraternal Orders is a Violation of the Equal Protection Aspect of the Fifth Amendment*, 18 VILL. L. REV. 93 (1972).

19. Section 170 (c) of the Internal Revenue Code of 1954 provides in part:

(c) Charitable Contribution Defined.—For purposes of this section, the term "charitable contribution" means a contribution or gift to or for the use of—

(4) In the case of a contribution or gift by an individual, a domestic fraternal society, order, or association, operating under the lodge system, but only if such contribution or gift is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals.

20. Section 501 (c) of the Internal Revenue Code of 1954 provides in part:

(c) List of Exempt Organizations.—The following organizations are referred to in subsection (a):

(8) Fraternal beneficiary societies, orders, or associations—

(A) operating under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system, and

(B) providing for the payment of life, sick, accident, or other benefits to the members of such society, order, or association or their dependents.

21. 338 F. Supp. at 457. *See also* Falkenstein v. Dep't of Rev., 350 F. Supp. 887, 889 (D. Or. 1972), *appeal dismissed sub nom.* Oregon State Elks Ass'n v. Falkenstein, 409 U.S. 1099 (1973); Pitts v. Dep't of Rev., 333 F. Supp. 662, 670 (E.D. Wis. 1971); Green v. Kennedy, 309 F. Supp. 1127, 1135 (D.D.C.), *appeal dismissed sub nom.* Cannon v. Green, 398 U.S. 956 (1970), *sub nom.* Coit v. Green, 400 U.S. 986 (1971).

22. 338 F. Supp. at 459.

In *Jackson*, the Second Circuit held that the requisite "significant" state involvement may result from an organization's enjoyment of tax exempt status. The court's analysis turned on its presentation of a five-factor "test" for determining the presence of state action. The *Jackson* court viewed the following as relevant criteria for determining whether state action was present: (1) the degree to which the private organization is dependent on governmental aid; (2) the extent and intrusiveness of the governmental regulatory scheme; (3) whether the regulatory scheme connotes government approval of the activity; (4) the degree to which the organization performs a public function; (5) whether the organization has legitimate claims to recognition as a private organization in either constitutional or associational terms.[23] According to the *Jackson* court, however, all these factors need not be present to find "state action."[24] The *Jackson* court thus correctly accepted the premise that state action may be found from a combination of several factors, even though each factor considered by itself may be insufficient.[25]

Seemingly, even the *McGlotten* and *Jackson* courts at least implicitly realize that not all tax exemptions make the recipient an arm of the state for fourteenth amendment purposes. Not even these courts would hold that an exemption granted to an individual transforms his conduct into constitutionally restricted state action. *McGlotten* attempts to limit the scope of its holding by advancing the "selected organization" concept while *Jackson* purports to formulate a further refinement by use of the five factors.

In his dissent to the Second Circuit's denial of reconsideration en banc, Judge Friendly attacked the panel's decision on several grounds. The dissenters principally objected to open endedness of the panel's opinion, that it ignored the problem of the requisite causal nexus between the action of the state and the alleged discrimination, and its potentially devastating effect on private philanthropy.

The dissenters believed the panel's position placed no ascertainable limitation on the use of tax exempt status in finding state action. Indeed, the dissent found "no really tenable basis for distin-

23. 496 F.2d at 629. It should be noted that each of the first four factors could independly be sufficient to support a finding of state action. *See, e.g.*, O'Neil, *Private Universities & Public Law*, 19 BUFFALO L. REV. 155 (1970); Schubert, *State Action & The Private University*, 24 RUTGERS L. REV. 323 (1970); Mayes, *Constitutional Restrictions on Termination of Services by Privately Owned Public Utilities*, 39 MO. L. REV. 205 (1974). In First Amendment cases, however, the Court seems to be restricting the concept of "public function". *See* Lloyd Corp. v. Tanner, 407 U.S. 551 (1972).

24. 496 F.2d at 634.

25. *See, e.g.*, Burton v. Wilmington Parking Auth. 365 U.S. 715 (1961).

guishing the tax deductions allowed individuals and corporations."[26] Even the *McGlotten* court conceded that here "no bright-line rule is possible."[27] Likewise, the *Jackson* panel recognized, albeit unwittingly, the sweeping scope of its holding by stating that on remand the defendant foundations may negate a finding of state action by showing that they somehow differed from "private foundations *generally*."[28]

It is questionable whether the five factors enumerated by the *Jackson* court will prove to be much assistance in determining which tax exemptions constitute state action. The first factor, "substantial dependence" on an exemption or deduction, will typically be present. Tax exempt organizations are often established for the very purpose of diverting potential tax dollars to other uses. Since the *Jackson* court found that the Internal Revenue Code's regulatory scheme for the prevention of abuse of tax exempt status was sufficiently extensive and intrusive, it would appear that the court's second factor will be satisfied in every tax exemption case. Concerning the third factor, it would seem that every tax benefit in some manner "connotes" government approval. "Connotation of government approval" is no less present in an investment credit given a corporation than an exemption granted a charitable foundation. The fourth factor, whether or not a "public function" is served by the entity receiving the tax exemption, is hardly helpful in light of the *Jackson* court's express inclusion of such diverse activities as research, hospital care, education, medicine, and the performing arts within its purview of "public function."[29] The number of activities which may arguably be characterized as "public functions" staggers the imagination.

The dissent furtherpoints to the problem of a failure to establish a causal nexus between the alleged discrimination and the state action. In *Powe v. Miles*,[30] the Second Circuit held that state regula-

26. 496 F.2d at 638 (Friendly, J., dissenting).

27. 338 F. Supp. at 457. The inadequacy of the *McGlotten* approach is perhaps best demonstrated by that court's analysis. The *McGlotten* court refused to find state action from the tax exemption granted social clubs under § 501(c)(7) of the Internal Revenue Code of 1954. In so holding, the court states at 458:

> Congress has simply chosen not to tax a particular type of revenue because it is not within the scope sought to be taxed by the statute.

It would seem that such reasoning would apply equally to fraternal benefit organizations and private charitable foundations. *See* Bittker & Kaufman, *supra* note 18, at 71.

28. 496 F.2d at 634 n. 17.

29. *Id.*

30. 407 F.2d 73 (2d Cir. 1968).

tion of educational standards in private schools could not constitute state action. In so holding, the court pointed out that:

> . . . The state must be involved not simply with some activity of the institution alleged to have inflicted injury upon a plaintiff but with the activity that caused the injury. Putting the point another way, the state action, not the private action, must be the subject of complaint.[31]

The Supreme Court approved this concept in *Moose Lodge No. 107 v. Irvis*,[32] where the Court refused to find that issuance of a liquor license by a state could "foster or encourage racial discrimination."[33]

The requirement of a direct causal nexus has recently been undermined by the Court in *Norwood v. Harrison*[34] and *Gilmore v. City of Montgomery*.[35] In *Norwood* the Court determined that the requisite state action was present in the granting of school books to discriminating private schools. In *Norwood* the Court states that:

> . . . The Constitution does not permit the State to aid discrimination even when there is *no precise causal relationship* between state financial aid to a private school and the continued well-being of that school. A State may not grant the type of tangible financial aid here involved if that aid has a significant tendency to facilitate, reinforce, and support private discrimination.[36]

Following the *Norwood* rationale, the Court in *Gilmore* held that a city could not give exclusive use of public recreational facilities to private all-white schools. The Court reasoned that:

> This means that any tangible state assistance, outside the generalized services government might provide to private segregated schools in common with other schools, and with all citizens, is constitutionally prohibited if it has a significant tendency to facilitate, reinforce, and support private discrimination.[37]

Norwood and *Gilmore* clearly support the premise that the

31. *Id.* at 81. *See also* Blackburn v. Fisk Univ., 443 F.2d 121, 124 (6th Cir. 1971); Browns v. Mitchell, 409 F.2d 593, 596 (10th Cir. 1969); Furumoto v. Lyman, 362 F. Supp. 1267 (N.D. Cal. 1973); Family Forum v. Archdiocese of Detroit, 347 F. Supp. 1167, 1172 (E.D. Mich. 1972); Mulvihill v. Butterfield Mem. Hosp., 329 F. Supp. 1020 (S.D.N.Y. 1971).

32. 407 U.S. 163 (1972).

33. *Id.* at 177, *But see* BASSETT, *The Reemergency of the "State Action" Requirement in Race Relations Cases*, 22 CATH. U.L. REV. 39, 48 (1973); *Tax Incentives as State Action, supra* note 18, at 436.

34. 413 U.S. 455 (1973).

35. ___ U.S. ___, 94 S. Ct. 2416 (1974).

36. 413 U.S. at 465-66 (emphasis added).

37. 94 S.Ct. at 2424.

nexus requirement of *Moose Lodge* is no longer intact in race discrimination cases. Assuming that a tax exemption is considered to be tangible state aid[38] within the scope of *Norwood* and *Gilmore*, it would appear that future tax exempt status cases will not be defeated solely because there is little relationship between the state action and the discrimination. The inevitable result of the *Norwood* rationale will be cases such as *Jackson*. If the Court follows the *Norwood* retraction of the causal nexus language in *Moose Lodge*, the result will surely be an unfortunate increase in federal court supervision of activities previously thought of as private.

Judge Friendly aptly observed that "[I]f the federal courts take over the supervision of philanthropy, there will ultimately be no philanthropy to supervise."[39] Benefactors generally want to be able to personally choose the object of their benevolence. Until *Jackson*, a private charitable foundation could accomplish this purpose without any worry of having to comply with the constitutional limitations applicable to governmental actions. The inevitable rash of court battles which will result from cases like *Jackson* cannot possibly prove conducive to charitable giving. Few individuals desire to have the assets of their charitable beneficiaries expended in the defense of lawsuits.

Jackson further raises an interesting question as to whether the actions of the federal government and federal officials are encompassed by section 1983 and the fourteenth amendment. Section 1983 refers to damages for deprivation of civil rights under color of *state* law.[40] Likewise, the fourteenth amendment places restrictions on the actions which a *state* may take.[41] In *District of Columbia v. Carter*,[42] a unanimous Supreme Court explained that:

> In contrast to the reach of the Thirteenth Amendment, the Fourteenth Amendment has only limited applicability; the commands of the Fourteenth Amendment are addressed only to the State or to those acting under color of its authority. Similarly, actions of the Federal Government and its officers are beyond the purview of the Amendment.[43]

Relying on *Carter*, the *Jackson* panel correctly ruled that only state

38. It is arguable that a tax exemption is not tangible financial aid within the scope of *Norwood* and *Gilmore*. *See* Walz v. Tax Comm'r, 397 U.S. 664 (1970).

39. 496 F.2d at 640 (Friendly, J., dissenting).

40. *See* statute quoted in note 10 *supra*.

41. *See* amendment quoted in note 9 *supra*.

42. 409 U.S. 418 (1973).

43. *Id.* at 423-24. *See also, e.g.*, Browns v. Mitchell, 409 F.2d 593, 595 (10th Cir. 1969).

tax exemptions could be considered in finding state action[44] for purposes of section 1983.[45] The *Jackson* panel placed no such limitation on the exemptions considered under the fourteenth amendment allegation. In light of the Supreme Court's recent language in *Carter*, it would appear that federal action should be irrelevant for purposes of state action under an alleged violation of the fourteenth amendment itself. Thus, the federal regulation and tax exemptions should not have been considered in attempting to establish state action under the fourteenth amendment.[46] Where *federal* discrimination is present, the petition should include an allegation of a fifth amendment violation.

The criticism leveled at the decision of the *Jackson* panel appears to be well justified. The *Jackson* case is a dangerous and unjustified expansion of the state action doctrine which is at war with the vast majority of precedent.[47] Unless corrected,[48] the *Jackson* decision could be the stepping stone toward federal court supervision of countless private activities.

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44. In United States v. Price, 383 U.S. 787, 794 (1966), the Court expressly equated the requirement of state action under the Fourteenth Amendment with the requisite state involvement under § 1983. Both concepts should now be treated equally.

45. 496 F.2d at 635.

46. This does not mean that racial discrimination by the federal government is tolerated. *See, e.g.*, Bolling v. Sharpe, 347 U.S. 497, 500 (1954). Federal discrimination is prohibited by means of the Due Process Clause of the fifth amendment. If a classification would be invalid under the Equal Protection Clause of the fourteenth amendment, it is also inconsistent with the due process requirement of the fifth amendment. Johnson v. Robison, 415 U.S. 361 (1974); Frontiero v. Richardson, 411 U.S. 677, 680 n.5 (1973).

47. *See, e.g.*, Walz v. Tax Comm'r, 397 U.S. 664 (1970); Grafton v. Brooklyn Law School, 478 F.2d 1137 (2d Cir. 1973); Bright v. Isenbarger, 445 F.2d 412 (7th Cir. 1971); Browns v. Mitchell, 409 F.2d 593 (10th Cir. 1969); Broderick v. Catholic Univ. of America, 365 F. Supp. 147 (D.D.C. 1973); Grossner v. Ttrustees of Columbia Univ., 287 F. Supp. 535 (S.D.N.Y. 1968).

48. Doubtless because of their confidence of prevailing on the merits, the foundations did not file a petition for certiorari. While it is no longer possible to reverse the *Jackson* decision itself, it is to be hoped that other courts will not see fit to follow in *Jackson's* path.

INJUNCTION OF TRAFFIC VIOLATIONS

State ex rel. Turner v. United-Buckingham Freight Lines, Inc.[1]

Defendant interstate trucking company violated an Iowa misdemeanor statute 1730 times during a 15 month period and was fined more than $30,000. The statute prohibited double-bottom troucks more than 60 feet in length from operating on Iowa highways.[2] The State, alleging that defendant's deliberate and repeated violations constituted a public nuisance, sought and was granted an injunction. United Buckingham appealed, asserting court error in finding the repeated violations a public nuisance, since there was no evidence of irreparable injury, and in granting the injunction, since criminal acts should not be enjoined. The Iowa Supreme Court affirmed, stating that the public is injured when the integrity of a statute is undermined by persistent violations, that equity has jurisdiction whether or not such conduct is labelled a public nuisance, and that the defendant was properly enjoined since no adequate remedy existed at law.

When a plaintiff seeks to enjoin a penal offense, the defendant generally invokes the maxim that equity won't enjoin the commission of a crime.[3] The maxim reflects a two-fold public policy: the plaintiff is adequately protected by the remedy at law, and the defendant is entitled to the safeguards of a criminal proceeding.[4] Exceptions to the maxim have always existed, however, so that a court in equity would grant an injunction against trespasses, purprestures (encroachments of the public way), and nuisances—conduct which violated the law but which also violated private or public property rights.[5] The exceptions to the rule today are so numerous and the criteria for enjoining so flexible that, according to one writer, the "court is in fact invited to do as it pleases."[6]

1. 211 N.W.2d 288 (Ia. 1973).

2. IA. CODE § 321.457(6) (1973).

3. D. DOBBS, HANDBOOK ON THE LAW OF REMEDIES § 2.11, at 115-16 (1973) (hereinafter cited as DOBBS).

4. 78 HARV. L. REV. 994, 1016 (1965). The objections to "criminal equity" include that it deprives the defendant of his jury trial; it deprives him of theprotection of the higher burden of proof required in criminal prosecutions; it may twice subject the defendant to punishment for the same acts—once for contempt for disobeying the injunction and again in a criminal prosecution; it substitutes a definite penalty fixed by the legislature for whatever punishment for contempt the court might see fit; and it "may result, or induce the public to believe that it results, in the arbitrary exercise of power and in government by injunction," 43 C.J.S. *Inj.* § 150 (1945).

5. *In re* Debs, 158 U.S. 564 (1895); 43 C.J.S. *Inj.* §§ 151, 152 (1945); DOBBS at 115-16. *See* Annots., 91 A.L.R. 315 (1934), 40 A.L.R. 1145 (1926).

6. DOBBS at 116.

Courts have been increasingly willing to issue injunctions against certain activities, albeit criminal, if they find that the conduct is a "public nuisance." A few courts refuse injunctive relief unless the legislature has defined the activity as a public nuisance and/or has expressly authorized such relief.[7] Many, however, require only that the conduct constitute a public nuisance,[8] conduct which "injuriously affects the safety, health or morals of the public or works some substantial annoyance, inconvenience, or injury to the public" or which is unlawful or antisocial and injures a substantial number of people.[9] A few courts have gone even further, rejecting the need to label the conduct a public nuisance and simply deciding whether equity should intervene.[10] For example, the South Carolina Supreme Court affirmed a decree restraining a defendant from the unlicensed practice of dentistry, a penal offense, saying, ". . . [T]he facts in this case present ample grounds for the intervention of equity. . . . There is present a high public interest which the State is entitled to have protected and the criminal remedy is inadequate to protect it. . . . [An injunction is necessary to protect the public from the defendant's] incompetency and inefficiency."[11]

The court in *United-Buckingham* held that the repeated violation of a criminal statute is enjoinable.[12] Although it emphasized that it is not necessary to label conduct a public nuisance in order to enjoin it, the court quoted an earlier decision[13] for the proposition that "The State has an interest in seeing that the law is not continually violated. Where a statute is openly, publicly, repeatedly, continually, persistently and intentionally violated a public nuisance is created."[14] The language thus endorsed is that of the Crawford Doc-

7. United States v. Parkinson, 240 F.2d 918 (9th Cir. 1956); Elizabeth City v. Aydlett, 200 N.C. 58, 156 S.E. 163 (1930).

8. DOBBS at 116; A.L.R. at 320 (1935); 40 A.L.R. at 1159 (1926).

9. 58 AM. JUR. 2d *Nuis.* § 7 (1971).

10. DOBBS at 116n.20. The court in *United-Buckingham* adopted this approach. 211 N.W.2d at 290.

11. State *ex rel.* McLeod v. Holcomb, 245 S.C. 63, 67, 138 S.E.2d 707, 708-09 (1964).

12. 211 N.W.2d at 290. *See also* State *ex rel.* Vance v. Crawford, 28 Kan. 518, 42 Am. Rep. 182 (1882); State *ex rel.* Peterson v. Martin, 180 Ore. 459, 176 P. 2d 636 (1947); State *ex rel.* Abbott v. House of Vision-Belgard-Spero, Inc., 259 Wisc. 87, 47 N.W.2d 321 (1951).

13. State *ex rel.* Turner v. Younker Bros., Inc., 210 N.W.2d 550, 564 (Ia. 1973). The case lends no support to the court's opinion. Defendant was enjoined from charging usurious interest rates. The only legal remedy was cancellation of excess interest on the unpaid balance; no criminal sanction was involved. The court held the practice a public nuisance, reiterating the common law definition of "unlawful or antisocial conduct that in some way injures a substantial number of people."

14. 211 N.W.2d at 290.

The only authority cited is Woods Bros. Thresher Co. v. Eicher, 231 Ia. 550, 1 N.W.2d 655 (1942). *Eicher* is not in point, for the situation there was reversed. Plaintiff was a private

trine which originated in an 1882 Kansas case: "We would think that every place where a public statute is openly, publicly, repeatedly, continually, persistently and intentionally violated, is a public nuisance."[15] The Iowa court distorts the doctrine, however, wrenching its original meaning from context for it refers to "every place" and has no ready application to a situation involving highways and trucks.

The original *Crawford* rule has been criticized by legal writers as too broad and rejected by many of the courts that have considered it.[16] Kansas itself has repudiated it.[17] The effect of the doctrine is to enjoin criminal conduct "when there is not only no actual injury to the community, but not even a remote possibility of injury. This appears to be a substantial departure from the settled law of nuisance."[18] A few courts nevertheless appear to embrace it;[19] the Iowa court seems to follow their lead and uses their language even though it rejects the need to designate the conduct a public nuisance.[20] The court in *United-Buckingham* did not require the State to prove that the defendant's repeated violations did cause or were likely to cause accidents. The court found that "[T]he public is injured when the integrity of the statute is . . . undermined."[21]

The Iowa court finds an injunction appropriate because the remedy provided by statute is inadequate to prevent the continual violations.[22] It reasons that the legal remedy is inadequate because it failed to halt the repeated violations, and an injunction should issue because the legal remedy is inadequate. Such analysis almost

party who sought to enjoin state highway officers. The "conduct subject to equitable jurisdiction" was that of state officials, not that of highway users; the issue involved statutory interpretation, not a defendant's repeated traffic offenses.

15. State *ex rel.* Vance v. Crawford, 28 Kan. 518, 522, 42 Am. Rep. 182, 186 (1882). The doctrine is dictum; a Kansas statute expressly made saloons operating in violation of the law a public unisance. Ironically, no injunction issued in *Crawford* because the statutory remedy—"Shut up and abate"—was quite adequate. *Id.* at 522, 42 Am. Rep. at 184-85.

16. 1953 WISC. L. REV. 163. *See* 25 BROOKLYN L. REV. 340 (1959).

17. State v. Barron, 136 Kan. 324, 15 P.2d 456 (1932).

18. 1953 WISC. L. REV. at 169.

19. State *ex rel.* Peterson v. Martin, 180 Ore. 459, 176 P.2d 636 (1947); State *ex rel.* Abbott v. House of Vision-Belgard-Spero, Inc., 259 Wisc. 87, 47 N.W.2d 321 (1951).

20. 211 N.W.2d at 290. Although the court gives no explanation for its refusal to label defendant's conduct a public nuisance, the possible reason emerges from an examination of the Iowa statutory definition of nuisance: "Whatever is injurious to health, indecent, or offensive to the senses, or an obstruction to the free use of property, so as essentially to interfere with the comfortable enjoyment of life or property, is a nuisance," IA. CODE § 657.1 (1973). The definition does not seem to cover United-Buckingham's use of over-length trucks, at least without evidence of injury to health or of obstruction.

21. 211 N.W.2d at 290.

22. 211 N.W.2d at 291.

obscures the holding—a repeated violation of a traffic law is enjoinable simply because it is a repeated offense. And since the persistent breach of *any* penal law "undermines the integrity of the statute," any repeated public welfare offense is, by analogy, enjoinable without any consideration of the specific facts involved or of the actual or potential injury caused by the defendant's conduct.

The Iowa court finds the remedy at law inadequate, since the defendant was fined 1730 times. The misdemeanor in question can carry up to a $100 fine or thirty days imprisonment. The possibility of jailing the truck drivers is mentioned and rejected as it would punish them for "infractions within the primary responsibility of their corporate employers."[23] But the court might yet have denied an injunction on grounds that an adequate legal remedy did exist, for Iowa Code section 321.484 (1973) provides, "It is unlawful for the owner, or *any* other *person*, employing or otherwise *directing the driver of any vehicle to require or knowingly permit* the operation of such vehicle upon a highway in any manner contrary to law."[24] The statute pertains not only to corporate owners but to "any person," so it would seem those responsible, those directing or permitting the continued offenses, might be threatened with a jail sentence—not under the auspices of an injunction but under the statute.[25]

In *United-Buckingham*, a repeated traffic violation is held to injure the public—injury sufficient to support an injunction—with no consideration of actual or threatened damage and no consideration of the constitutional aspects of enjoining a crime.[26] The legislature provided what it thought were appropriate penalties; if such penalties are ineffective, it could increase them or provide special treatment for chronic offenders. There is little or no precedent for the court's action.[27] The cases cited in support are not in point. They

23. 211 N.W.2d at 292.

24. IA. CODE § 321.484 (1973) (emphasis added).

25. The effectiveness of this remedy may depend on the court's ability to obtain personal jurisdiction over the defendant manager or owner.

26. *See* note 4 *supra*.

27. The situation in England is apparently somewhat different. 22 MOD. L. REV. 535 (1959), surveys a recent trend toward relator actions to enjoin repeated violators and says, "[T]here have been strong dicta to the effect that the question whether the defendants' conduct has in fact caused or tended to cause injury to the public is not one into which [the courts] can properly inquire." But in Att'y-Gen. v. Harris, 2 All E.R. 393, 3 W.L.R. 205 (1959), a flower-vendor who had been fined 189 times for plying his trade on Sunday was not enjoined. The court said its duty was to inquire whether defendant's acts in truth injured the public. The article sees *Harris* as a "useful corrective to recent trends in other directions" and believes injunctions should be confined to serious cases of manifest urgency. 22 MOD. L. REV. at 538.

are either easily distinguishable on the facts or involve statutes expressly authorizing injunctive relief or affording no criminal sanctions at all.[28]

An injunction is a strong weapon. A court should issue an injunction only after it determines that the legal remedy is clearly inadequate and that the harm threatened is substantial. The Iowa court's approach to the problem in *United-Buckingham* is questionable because it supports enjoining conduct simply and solely because statute is persistently violated.[29]

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28. Three of the nine cited cases deal with loan shark businesses charging usurious interest rates and, in at least two of these, the only statutory remedy was cancellation of excess interest; no act punishable criminally was involved. State *ex rel.* Turner v. Younker Bros., Inc., 210 N.W.2d 550 (Ia. 1973); State v. Hooker, 87 N.W.2d 337 (N.D. 1957); State *ex rel.* Beck v. Basham, 146 Kan. 181, 70 P.2d 24 (1937). Two are rock festival cases in which the promoters did not obtain the required health and safety licenses; one of these reviews contempt charges, and the other has no issue as to persistent violations. Sound Storm Enterprises, Inc. v. Keefe, 209 N.W.2d 560 (Ia. 1973); Planning & Zoning Comm'n v. Zemel Bros., Inc., 29 Conn. Supp. 45, 270 A.2d 562 (1970). Another cited case deals with the constitutionality of a statutory minimum on milk prices where injunctive relief was authorized by statute. Montana Milk Control Bd. v. Rehburg, 141 Mont. 149, 376 P.2d 508 (1962). In two others, the plaintiff is not the government. National Ass'n of Letter Carriers, AFL-CIO v. Independent Postal System of Am., Inc., 470 F.2d 265 (10th Cir. 1972) (suit to enjoin labor union); Wood Bros. Thresher Co. v. Eicher, 231 Ia. 550, 1 N.W.2d 655 (1942) (suit to enjoin government officials).

The Iowa court ignores the subsequent history of the ninth case it cites, State v. Red Owl Stores, Inc., 253 Minn. 236, 92 N.W.2d 103 (Minn. 1958), 262 Minn. 31, 115 N.W.2d 643 (1962). The State of Minnesota sought to enjoin defendant supermarket chain from selling such drugs as Alka-Seltzer, Anacin, and Ex-Lax, alleging violations of the Pharmacy Act which made it unlawful to sell drugs in unlicensed outlets. The court reversed the trial court and granted plaintiff a new trial, saying the State had a prima facie case in view of the public policy that uncontrolled sale of drugs and medicine was inimical to public health. A strong dissent observed that neither injury nor inadequancy of legal remedy had been shown. The language of a broad but controlling public policy sounds much like the language of *United-Buckingham*. The most pertinent point of the *Red Owl* case, however, is that on retrial the trial court denied the injunction, finding the drugs were not covered by the statute. The supreme court, while reversing in part by holding the drugs within the Act's coverage, affirmed the denial of the injunction on grounds that the sales were not shown to be nuisances or dangers to the public health; proof of specific injury was necessary.

29. Injunctions will lie in Missouri to "prevent the doing of any legal wrong whatever, whenever in the opinion of the court an adequate remedy cannot be afforded by an action for damages." § 526.030, RSMo 1969. A literal reading could authorize enjoining a continual violator of a public welfare offense from committing future infractions. Case law suggests a narrower construction: "[A] court of equity is powerless to enjoin the commission of any crime not violative of property rights nor involving the creation of a public nuisance." State *ex rel.* Chicago, B.&Q.R. v. Woolfolk, 269 Mo. 389, 190 S.W. 877 (En Banc 1916); a public nuisance can be enjoined, but "there must be proof of the nuisance, as distinguished from the mere crime," and an injunction will not lie to prevent or punish the commission of a crime, State *ex rel.* Alton v. Salley, 215 S.W. 241 (Mo. 1919).

EVIDENCE—THE RIGHT OF CONFRONTATION—EXCEPTIONS TO THE HEARSAY RULE AND THE SCOPE OF THE CONFRONTATION CLAUSE

State v. Rowlett[1]

The state charged Sidney B. Rowlett with the murder of Robert Bussen. The State's theory was that one William Herron did the actual killing at Rowlett's direction in order to prevent the victim from being a witness against Rowlett in a narcotics case. At Rowlett's trial Herron was called as a witness for the State. He gave his name and stated that he resided at the Missouri State Penitentiary. He refused to answer all other questions on the grounds of self-incrimination. Herron was asked whether he had pleaded guilty to a charge of murder in the first degree. The trial court rejected the witness's claim of privilege against self-incrimination and directed the witness to answer. The witness again refused. Over objection of defense counsel the court permitted the State to read Herron's guilty plea from the former proceeding. Rowlett was found guilty.[2]

Rowlett appealed the conviction on the ground that the introduction of Herron's guilty plea denied him the right to confront the witnesses against him as guaranteed by the sixth amendment of the United States Constitution,[3] and article 1, § 18(a) of the Missouri State Constitution.[4]

In reversing the conviction the Missouri Supreme Court decided that *Kirby v. United States*[5] controlled and that the admission of Herron's guilty plea violated Rowlett's right of confrontation,[6] stating however:

> Were the court at liberty to determine the admissibility of the evidence here in question without constraint of prior decision of the United States Supreme Court, the state's contention that the evidence amounted to proof of a prior statement against penal interest, and was thus fully within a recognized exception to the hearsay rule and did not offend the constitutional guaranty of the right of confrontation, might well be persuasive.[7]

1. 504 S.W.2d 48 (Mo. 1973).
2. *Id.* at 49.
3. The sixth amendment provides: "In all criminal prosecutions, the accused shall enjoy the right . . . to be confronted with the witnesses against him. . ."
4. Article 1 § 18(a) states: "That in all criminal prosecutions the accused shall have the right . . . to meet the witnesses against him face to face. . ."
5. 174 U.S. 47 (1899).
6. 504 S.W.2d 48, 54 (Mo. 1973).
7. *Id.* at 52.

This language indicates the court's willingness to accept the premise that once evidence is admissible under an exception to the hearsay rule, the requirements of the state and federal confrontation clauses are met. It is also in accord with Missouri decisions based on the Missouri confrontation clause[8] and with the trend of United States Supreme Court decisions. The court's failure to follow this rationale, and its reliance on the 1899 *Kirby* case must be considered in light of the history of the hearsay and confrontation doctrines and cases interpreting these rules.

When the sixth amendment was adopted in 1782, the hearsay rule had been established in England for more than a century.[9] Certain exceptions to the hearsay rule, however, were generally accepted.[10] The confrontation clause was adopted to prevent the use of *ex parte* affidavits and depositions in lieu of witnesses in criminal trials.[11] The main purpose of the clause was to give defendants in criminal proceedings the right of cross-examination. The presence of the witness also allowed the judge and jury to view the witness's demeanor and make a more informed judgment concerning the reliability of the testimony given.[12]

In *Mattox v. United States*[13] the United States Supreme Court first established criteria for determining whether the admission of evidence violated the confrontation clause. Mattox was convicted of murder but the conviction was reversed on appeal and a new trial was ordered. Two witnesses had died since the first trial and the prosecutor read their former testimony into evidence in the second trial. The Court found no violation of the confrontation clause.[14] The Court stated:

> There is doubtless reason for saying that the accused should never lose the benefit of any of these safeguards even by the death of the witness . . . But general rules of law ofthis kind . . . must occa-

8. *See* note 51 *infra*.

9. C. McCORMICK, LAW OF EVIDENCE § 252, at 606 (1972).

10. The exceptions included former testimony; Rex v. Vipont, 2 Burr. 1163, 97 Eng. Repr. 767 (1761); Rex v. Radbourne, 1 Leach C.L. 457 (1787); Rex v. Jolliffe, 4 Term R. 285, 100 Eng. Repr. 1022 (1791); Annot., 15 A.L.R. 498,500; and dying declarations 5 J. WIGMORE, EVIDENCE § 1430; C. McCORMICK, LAW OF EVIDENCE § 252, at 606 (1972).

11. Douglas v. Alabama, 380 U.S. 415, 418 (1965); Mattox v. United States, 156 U.S. 237, 242 (1895).

12. Mattox v. United States, 156 U.S. 237, 242-43 (1895); J. WIGMORE, EVIDENCE § 1395 (1940); *see also* Davenport, *The Confrontation Clause and the Co-Conspirator Exception in Criminal Prosecutions: A Functional Analysis*, 85 HARV. L. REV. 1378 (1972).

13. 156 U.S. 237 (1895).

14. *Id.* at 238.

> sionally give way to considerations of public policy and the necessities of the case.[15]

The Court in this early case recognized that the confrontation clause is not a total bar to the admission of out of court statements. The Court looked to the necessity of admitting the witness's prior statements. Had the *Rowlett* court looked at the necessity for admitting the guilty plea and its inherent reliability a different result might well have followed.

The next significant development in this area was *Kirby v. United States*,[16] the case upon which the decision in *State v. Rowlett* is based. Kirby was convicted of receiving stolen property of the United States Government. A statute provided that a judgment against the thief would be conclusive evidence in the trial of the receiver that the property was stolen. Wallace, Baxter, and King stole stamps from a post office, and Kirby received the goods. At Kirby's trial the prosecution offered into evidence part of the record from the trial of King, Baxter, and Wallace. The record indicated that Wallace and Baxter pleaded guilty while King pleaded not guilty but was convicted. The court instructed the jury that the record of conviction made out a *prima facie* case that the property was stolen. Kirby objected to the admission of the record on the ground that the statute was unconstitutional.[17]

The Supreme Court found the statute unconstitutional. The Court stated that the record of the conviction of the principal felons was not admissible for any purpose.[18]

The exact reasoning behind this decision is extremely difficult to discern from the language of the decision. The Court stated:

> We are of the opinion that the trial court erred in admitting in evidence the record of the convictions of Wallace, Baxter and King, and then in its charge saying that in the absence of proof to the contrary, the fact that the property was stolen from the United States was sufficiently established against Kirby by the mere production of the record showing the conviction of the principal felons.[19]

This statement seems to indicate that it was the admission of the record of conviction and not the admission of the guilty plea which violated Kirby's right to confrontation. The Court went on, how-

15. *Id.* at 243.
16. 174 U.S. 47 (1899).
17. *Id.* at 47-50.
18. *Id.* at 60.
19. *Id.* at 53-54.

ever, to discuss the fact that Kirby was not present when the guilty pleas were entered and therefore could not cross-examine Wallace and Baxter.[20] The Court further emphasized the impropriety of the admission of the record of convictions, however, saying:

> And yet the court below instructed the jury that the conviction of the principal felons upon an indictment against them alone was sufficient *prima facie* to show, as against Kirby, . . . the existence of the fact that the property was stolen . . . .[21]

Later, the Court again emphasized the error of introducing the "result" of the trial of the principal felons.[22] The Court, therefore, failed to make it clear whether it was the admission of the guilty pleas, the record of the convictions, or the procedural effect of such admissions under the statute in question which violated Kirby's constitutional rights.[23]

Kirby was the first case to analyze the *Mattox* "necessity" approach to the confrontation clause. After stating in dicta that the dying declaration exception to the confrontation and hearsay rules arises from the necessity of the case,[24] the Court discussed the inherent reliability of such statements. The Court stated that the ground upon which this exception rests is that due to the surrounding circumstances ". . . [t]hey are equivalent to the evidence of a living witness upon oath. . . ."[25] This statement indicates that in addition to unavailability, there must be some indication that the statement was reliable and that the declarant was telling the truth. To satisfy the confrontation clause after *Kirby*, two factors must be present: some necessity for the evidence's admission, and the reliability of the evidence.[26] Had the *Rowlett* court relied on this analy-

20. *Id.* at 54.

21. *Id.* at 54-55.

22. *Id.* at 55.

23. It is important to note that the prosecutor in *Kirby* made no showing that the principal felons were unavailable to testify, and the case therefore could have been decided by a straight-forward application of *Mattox*. The failure to allege unavailability also raises hearsay problems. The guilty pleas could not fall under the declaration against interest exception to the hearsay rule without a showing of unavailability. *See* C. MCCORMICK, LAW OF EVIDENCE, §§ 276, 280, at 670, 678 (1972); PROP. FED. R. EVID. 804 (b)(4) (1972). The judgement against the principal who pleaded guilty would not have been admissible under an exception to the hearsay rule even if the witness had been unavailable. *See* PROP. FED. R. EVID. 803 (22) (1972).

24. 174 U.S. at 61.

25. *Id.* at 61.

26. The confrontation cases following *Kirby* add little to the analysis of these issues. Each however, points out that confrontation is not an absolute bar and that exceptions to the rule exist. *See* West v. Louisiana, 194 U.S. 258,260-61 (1904), (deposition admitted when witness unavailable and defendant had opportunity to cross examine when deposition was

sis, the evidence might have been ruled admissible. The witness was unavailable for cross-examination since he invoked the fifth amendment,[27] and his plea was against his penal interest, supplying a sufficient assurance of reliability.[28]

Though these factors are very similar to those used in analysis of hearsay exceptions, two later cases distinguish the confrontation clause and the hearsay rule. In *Pointer v. Texas*[29] the Supreme Court held it error to admit at trial testimony given by a witness at a preliminary hearing where the defendant was present and could cross-examine, but was not represented by counsel.[30] This testimony would have been admissible in Texas under the prior reported testimony exception to the hearsay rule. This exception requires that the witness be unavailable and that the defendant had an opportunity to cross examine.[31] The Supreme Court, however, stated that the mere opportunity to cross examine is not enough. The confrontation clause must be read in conjunction with the sixth amendment right to counsel.[32] The Court, therefore, based its decision on the confrontation clause and on the right to counsel.[33]

Barber v. Page[34] also indicates the confrontation clause does not have the same limits as the hearsay rule. At Barber's trial the court admitted the transcript of a witness's testimony at a preliminary hearing. At the time of the trial this witness was in a federal prison in an adjoining state. The prosecution made no effort to produce

taken); Dowdell v. United States, 221 U.S. 325, 330 (1911), (". . . this general rule of law embodied in the Constitution [the confrontation clause] . . . has always had certain well recognized exceptions"); Salinger v. United States, 272 U.S. 542, 548 (1926), (the purpose of the confrontation clause was not to broaden the common law rule or disturb its exceptions.)

27. 504 S.W.2d at 51. State v. Yates, 442 S.W.2d 21, 28 (Mo. 1969) (where witness invokes the privilege against self incrimination, the unavailability requirement is satisfied.) Osbourne v. Purdome, 250 S.W.2d 159 (Mo. En Banc 1952); Sutton v. Easterly, 354 Mo. 282, 189 S.W.2d 284 (Mo. 1945); See also United States v. Elmore, 423 F.2d 775 (4th Cir. 1970); United States v. Mobley. 421 F.2d 345 (5th Cir. 1970) (refusal to testify based on unjustified reliance on the fifth amendment); Mason v. United States, 408 F.2d 903 (10th Cir. 1969) (same unjustified reliance); Annot. 45 A.L.R. 2d 1354; C. McCORMICK, LAW OF EVIDENCE, § 253, at 612 (1972); PROP. FED. R. EVID. 804 (a)(2) (1972).

28. *See* note 50 *infra*. It should also be noted that the indicia of reliability in this case is very strong indeed. The plea of guilty to a first degree murder charge was obviously not the result of any plea bargaining.

29. 380 U.S. 400 (1965).

30. *Id.* at 401-402. It must be noted that Bruton v. United States, 391 U.S. 123 (1968) has no application to the facts at hand since the confession of Herron was not admitted to prove Rowlett's guilt.

31. *See* PROP. FED. R. EVID. 804(b)(1) (1972).

32. 380 U.S. 400, 407 (1965).

33. This case is also important because the Court held that the confrontation clause is binding on the states. *Id.* at 403.

34. 390 U.S. 719 (1968).

him at trial. The Supreme Court held that it was error to admit the transcript. The Court stated that a witness is not unavailable for confrontation clause purposes unless the state makes a good faith effort to obtain his presence.[35] This expanded the unavailability requirement beyond what is necessary in the hearsay area.[36]

In *Barber* and *Pointer* the Court indicated that hearsay and confrontation are not co-extensive in scope. In each case the hearsay exception was satisfied but the confrontation clause was violated.[37] The cases since *Barber*, however, indicate a relaxtion of the confrontation clause requirement.

In *California v. Green*[38] a state's witness claimed that he remembered nothing of prior statements that he had made concerning the defendant's guilt or of his testimony at a preliminary hearing. The defendants attorney had cross-examined the witness at the preliminary hearing. This previous testimony was introduced into evidence to refresh the witness's memory under a California statute allowing admission for the purpose of proving the truth of the matter asserted. The Court held that neither this admission nor the statute violated the confrontation clause.[39] The Court did state that the confrontation clause is not a mere codification of hearsay rules,[40] but also stated: "[T]he Confrontation Clause is not violated by admitting a declarant's out of court statements as long as the de-

35. *Id.* at 720-25.

36. It is unclear whether the Proposed Federal Rules specifically embody the *Barber* requirement of actual unavailability. Rule 804(a)(5) states that unavailability will be found where the witness "Is absent from the hearing and the proponent of his statement has been unable to procure his attendance by process or other reasonable means." As a practical matter, the words "other reasonable means" will have to be read, in criminal prosecutions, to include the actual unavailability requirement of *Barber*. *See* Mancusi v. Stubbs, 408 U.S. 204, 209 (1972) (the witness was not merely absent from the state, but was also a permanent resident of Sweden).

37. The confrontation cases immediately preceeding *Barber* add little to the confrontation analysis. In Douglas v. Alabama, 380 U.S. 415, 416, 417, (1965), a prosecutor read the confession of an alleged accomplice who was then on the stand but refused to answer any questions. The prosecutor justified the action on the basis of "cross examining a hostile witness". The confession implicated the defendant. The court found this violated the defendant's right to confrontation. Justice Harlan stated in Dutton v. Evans, 400 U.S. 74, 98 (1970) that *Douglas* is most easily dealt with by viewing it as a case of prosecutorial misconduct. No matter how the case is viewed, the decision is easily squared with the other cases applying the necessity doctrine. The evidence submitted clearly fails to meet the reliability requirement of the necessity test since the part of the alleged confession implicating the defendant is not against the interest of the declarant. *See* Bruton v. United States, 391 U.S. 123 (1968); Taylor, *Codefendant's Confession in a Joint Trial*, 35 Mo. L. Rev. 125 (1970). This part of the confession would also fail to meet an exception to the hearsay rule.

38. 399 U.S. 149 (1970).

39. *Id.* at 151-53.

40. *Id.* at 155.

clarant is testifying as a witness and subject to full and effective cross-examination."[41]

Any notion that *Green* established a strict requirement that the out of court declarant be available for cross-examination was dispelled in *Dutton v. Evans*.[42] At the trial of *Evans*, the state called a cell-mate of one of the defendant's co-conspirators. This witness testified that his cell-mate, Williams, had said: "if it hadn't been for that dirty son-of-a-bitch Alex Evans, we wouldn't be in this now." The statement was admitted over the objection of Evans under the co-conspirator exception to the hearsay rule.[43] The Court found no violation of the confrontation clause.[44] The plurality opinion emphasized the "indica of reliability" of the evidence,[45] and stated that the witness was vigorously cross-examined by the defendant.[46] This result is quite extraordinary in light of the *Barber* decision since no attempt was made to call the declarant, Williams to the stand and the court failed to require any attempt to do this. Justice Stewart based his decision on two grounds: first that the evidence was not "in any sense crucial or devastating;"[47] and, secondly, that the evidence had sufficient indicia of reliability since it was against the penal interest of Williams.[48] No matter how questionable the analysis, it is apparent that the plurality opinion was still attempting to analyze the issues within the frame of reliability.

As *Dutton* and *Green* demonstrate, the Supreme Court has been reluctant in recent decisions to use the confrontation clause to strike down the admission of evidence admissible under an exception to the hearsay rule.[49] The Missouri court in *Rowlett* states that Herron's guilty plea is a declaration against penal interest and therefore probably fits within the hearsay exception.[50] Thus the

41. *Id.* at 158.

42. 400 U.S. 74 (1970). It should be noted that *Dutton* was not a five man decision.

43. *Id.* at 74-78.

44. *Id.* at 89.

45. *Id.* at 89. The court focused on the spontaneity of the declarant's statement and the fact that the statement was against his penal interest.

46. *Id.* at 86. As in the *Green* case, it is difficult to find how cross-examination would help the defendant in the case. The declarant is not on the stand, and it is *his* sincerity that must be tested, not that of his cellmate.

47. *Id.* at 87.

48. *Id.* at 89.

49. *See* Nelson v. O'Neil, 402 U.S. 622 (1971), (declaration against penal interest); Mancusi v. Stubbs, 408 U.S. 204 (1972), (prior reported testimony); *See also* Chambers v. Mississippi, 410 U.S. 284 (1973), (where the court held that the hearsay rule could not be used to deny the defendant his right to confrontation. This indicates that in certain circumstances, if suitable "indicia of reliability" exists, confrontation can require the admission of evidence even though no hearsay exception is met.)

50. 504 S.W.2d 48, 52 (Mo. 1973). The court also indicates that if the evidence was some

court could have followed the analysis used in more recent Supreme Court decisions and found the record of the guilty pleas admissible.

In conclusion, the Missouri Supreme Court based its decision solely on the *Kirby* case. As indicated above it is unclear whether the *Kirby* Court meant to set up an absolute bar against such a use of co-conspirators guilty pleas, whether the Court only meant to bar introduction of records of the convictions, or whether the Court objected to the procedural effects of the state statute. In light of this ambiguity the Missouri Supreme Court might have reached a different result by noting that the *Kirby* court considered the necessity for admitting the evidence as well as the reliability. The court then, without resorting to an ambiguous 1899 decision, could have based its holding on the more recent interpretation of the confrontation clause and analyzed the "indicia of reliability" and the availability of the declarant as the *Green* Court did. Using this analysis, the court could simply have stated that there was sufficient indicia of reliability since the statement was against penal interest and that the *Mattox* and *Barber* necessity requirements were met because the witness refused to testify and, therefore, his plea of guilty should be admitted.[51] The court then could have followed the Missouri cases indicating that, if a hearsay exception is met, the Missouri confrontation requirement is satisfied.[52]

The effect of this decision is to engraft a strict rule of exclusion against the admission of guilty pleas in such instances onto the Missouri confrontation clause. Such a rule is not likely to be required by the United States Supreme Court if the analysis of necessity and reliability continues in the confrontation area.

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other form of declaration against penal interest that there would be no violation of the right to confrontation. This is in conflict with State v. Gorden, 356 Mo. 1010, 1014, 204 S.W.2d 713, 715 (Mo. 1947) which held that admission of a declaration against penal interest did violate the Missouri confrontation clause. *Rowlett* is consistent, however, with State v. Spica, 389 S.W.2d 35 (Mo. 1965), which stated that if there is a valid hearsay exception satisfied there is no violation of the right of confrontation. *Id.* at 46. *See* State v. Colvin, 226 Mo. 446, 126 S.W. 448 (1910).

51. *See* cases cited in note 27 *supra.*

52. *See* cases cited note 51 *supra.*

PARTNERSHIP—THE EFFECT OF FAILURE TO SHOW EXPRESS AGREEMENT—IMPLIED PARTNERSHIP IN MISSOURI

Grissum v. Reesman[1]

Elwood Grissum died March 5, 1970, leaving real estate and personal property worth approximately $286,405. Decedent willed his entire estate to Nora Grissum, his sister. Nora filed an action in equity to have her brother's estate declared partnership property, with one-half going immediately to her. Since this would have meant a net difference of over $57,000 in estate and inheritance taxes, the State of Missouri was made a defendant.[2] Nora contended that in the 1930's, she and her brother orally created a partnership to operate a farm, to accumulate property, and to share the profits equally. The Circuit Court of Cooper County found for Nora and the State appealed, claiming that the evidence did not sufficiently establish a partnership.[3] The Supreme Court of Missouri found that there was "clear, cogent, and convincing" evidence[4] to show the existence of a partnership and affirmed.[5]

Since 1949, the law concerning partnerships in Missouri has been embodied by the Uniform Partnership Act.[6] On the subject of determining the existence of a partnership, its terms are quite general. Section 358.060, RSMo 1969, states that "any association . . . is not a partnership under this law, unless such association would have been a partnership in this state prior to the adoption of this law." *Grissum* has to some extent clarified that law.

A partnership is a voluntary association of two or more persons to combine their investments or energy in a lawful business enterprise.[7] It is characterized by the sharing of profits and losses and is based on a contract between the parties.[8] Where no express written

1. 505 S.W.2d 81 (Mo. 1974).

2. *Id.* at 83. The original caption of the case showed Nora Grissum as plaintiff and defendant. An Administrator *ad Litem* was later appointed. The caption was changed by the Supreme Court but the State alone appealed.

3. *Id.* at 85. The State also objected to the admission of "collateral evidence" and claimed the action violated the Statute of Frauds. *Id.*

4. *Id.* at 86.

5. *Id.*

6. §§ 358.010-.430, RSMo 1969.

7. Van Hoose v. Smith, 355 Mo. 799, 198 S.W.2d 23 (1946); Chapin v. Cherry, 243 Mo. 375, 147 S.W. 1084 (1912).

8. Temm v. Temm, 354 Mo. 814, 191 S.W.2d 629 (1946); Dixon v. Dixon, 181 S.W. 84 (Mo. 1915). A party alleging the existence of a partnership faces a substantial problem when the contract is oral. Such was the case in *Grissum*, where the problem was compounded because Nora was prevented from testifying by the Missouri Deadman's Statute, § 491.010, RSMo 1969. In *Grissum*, no oral contract was found.

or oral agreement can be shown, a contract of partnership may be implied from the behavior of the parties.[9] The apparent intent of the parties determines the existence of the partnership.[10] Whether the parties shared profits and losses has traditionally been a critical consideration regarding this intent.[11]

Section 358.070(4), RSMo 1969, provides that the receipt of profits by a person in a business raises a rebuttable presumption that he is a partner in that business. The facts in *Grissum* with regard to profit sharing were not definitive. Nora and Elwood lived together on the farm and shared expenses. A substantial part of the farm income was reinvested in the farm. Nora, however, had no bank account in her own name and paid no personal income tax on farm income before 1970. Although a large amount of money[12] was placed in various joint accounts after 1967, there was no evidence that Nora ever drew on any profits for her personal benefit.[13] While the court possibly could have concluded that Nora and Elwood shared profits, it did not. Instead, the court found that while neither party sought to make personal use of the profits, both had the *right* to receive profits at any reasonable time.[14]

It seemed clear before *Grissum* that courts would not imply a partnership in the absence of an actual distribution of profits.[15] Although it did not expressly overrule any prior case, the obvious consequence of *Grissum* is that an actual distribution of shared profits may no longer be needed to establish a partnership by implication. The court did not, however, reach the question of whether the right to share profits could now be considered *prima facie* evidence of a partnership. Such an interpretation involves a more liberal reading of the Uniform Partnership Act than any court has previously given it, and does not seem likely. Nor did the court abandon profit sharing completely as a requirement of partnership. Although *Grissum* liberalizes the profit sharing requirement, any proof that an alleged partner did not have the right to share profits will almost certainly be fatal to the claim.

While an agreement not to share losses may preclude the exist-

9. Schneider v. Schneider, 347 Mo. 102, 146 S.W.2d 584 (1941); Neville v. D'Oench, 327 Mo. 34, 34 S.W.2d 491 (1931); Priest v. Chouteau, 12 Mo. App. 252 (St. L. Ct. App.), *aff'd*, 85 Mo. 398 (1882).

10. MacDonald v. Matney, 82 Mo. 358 (1884). *See* text accompanying notes 20-25 *infra*.

11. Maclay v. Freeman, 48 Mo. 234 (1871).

12. Approximately $80,000. 505 S.W.2d at 83.

13. *Id.* at 87.

14. *Id.*

15. *See e.g.*, Shawneetown Feed & Seed Co. v. Ford, 468 S.W.2d 54 (St. L. Mo. App. 1971).

ence of a partnership,[16] the absence of any agreement on the subject probably will not.[17] If all other requirements of a partnership are met, the court will imply an obligation to share in any losses.[18] It may actually be easier to show a partnership without an express agreement about loss sharing.[19]

The existence of a partnership is a question of the intent of the parties involved.[20] In *Schneider v. Schneider*,[21] the court pointed out that it is not necessary that "each of the parties . . . fully understand all of the legal incidents which follow upon partnership existence."[22] Their conduct under the arrangement is evidence of their intent. The sort of evidence required may vary with the circumstances of the case. Intention may be measured by the degree of participation of the parties in management of the business,[23] the ownership status of the parties with regard to business property,[24] or the statements and actions of the parties as they can be construed under the alleged partnership.[25] *Grissum* seems to indicate that, unlike the profit sharing requirement, the absence of any of these factors will not necessarily prevent the existence of a partnership.[26]

In *Grissum*, Nora was able to prove that she was consulted about most business decisions, that she kept all of the books, made the bank deposits, and paid all of the bills. Witnesses testified to many admissions by Elwood showing that he considered the busi-

16. Gill v. Ferris, 82 Mo. 156 (1884); Bussinger v. Ginnever, 213 S.W.2d 230 (St. L. Mo. App. 1948).

17. Hindman v. Secoy, 218 S.W. 416 (Spr. Mo. App. 1920).

18. Schneider v. Schneider, 347 Mo. 102, 146 S.W.2d 584 (1941).

> [W]here there is an agreement to share profits and no clear understanding that the losses are not to be divided, a partnership may be implied which would carry with it the obligation to participate in the payment of losses.

Id. at 108, 146 S.W.2d at 588-89. Lengle v. Smith, 48 Mo. 276 (1871).

19. If the language of an agreement is unclear, the parties may be bound by their words and not their intentions. *See* Skinner v. Whitlow, 184 Mo. App. 229, 167 S.W. 463 (St. L. Mo. App. 1914).

20. Temm v. Temm, 354 Mo. 814, 191 S.W.2d 629 (1946); Prasse v. Prasse, 77 S.W.2d 1001 (Mo. 1934); Bussinger v. Ginnever, 213 S.W.2d 230 (St. L. Mo. App. 1948). *See e.g.*, Shawneetown Feed & Seed Co. v. Ford, 468 S.W.2d 54 (St. L. Mo. App. 1971) (creditor seeking access to his debtor's alleged partnership property); Neville v. D'Oench, 327 Mo. 34, 34 S.W.2d 491 (1930) (plaintiff seeking an accounting from an alleged partner).

21. 347 Mo. 102, 146 S.W.2d 584 (1940).

22. *Id.* at 107, 146 S.W.2d at 588.

23. Allison v. Dilsaver, 387 S.W.2d 206 (Spr. Mo. App. 1965); Troy Grain & Fuel Co. v. Rolston, 227 S.W.2d 66 (K.C. Mo. App. 1950).

24. Such ownership is generallyinconclusive. *See* Deyerle v. Hunt, 50 Mo. App. 541 (K.C. Ct. App. 1892).

25. Fyock v. Riales, 251 S.W.2d 102 (Spr. Mo. App. 1952).

26. Joint ownership of business property was one of the elements missing in *Grissum*. *See* Neville v. D'Oench, 327 Mo. 34, 34 S.W.2d 491 (1930).

ness a "50-50 proposition" and intended to "fix things up" so that "Nora would be protected sometime."[27] Evidence was also introduced that several signs on the farm and farm equipment proclaimed "Elwood and Nora Grissum's Farms."[28] Thus, in the opinion of thecourt, these factors outweighed the fact that all farm property was in Elwood's name and that no partnership income tax returns were filed before Elwood's death. The court emphasized that people like Nora and Elwood Grissum cannot be expected to know the formal requirements of a partnership.[29] Although Nora and Elwood did not manifest their desire to establish a partnership by the most rational legal means available, it was obvious to the court what their intentions were.[30]

No consistent verbalization of the required degree of proof had appeared in previous Missouri appellate decisions dealing with the existence of implied partnerships. Various decisions refer to "a preponderence of the evidence,"[31] "clearest and most positive evidence,"[32] and "cogent, clear and convincing evidence."[33] *Grissum* attempts to establish a uniform standard of proof for future cases, and to further define that standard so it is workable. Recognizing that such formulas are only vague guidelines, the court adopted, at least where the conveyance of property is involved, the "clear, cogent, and convincing" test.[34] This means that the party with the burden of proof must "clearly convince" the court that the requirements of partnership were met. "Cogent" means only that the evidence appeal to the court's reasoning, particularly when the backgrounds of the parties are considered.[35] Parties with a working knowledge of the business world could probably not show a partnership with the same type of evidence used in *Grissum*. Although the court probably does not intend to make this a completely subjective test, it seems that the parties' respective positions and knowledge

27. 505 S.W.2d at 84.
28. *Id.*
29. *Id.* at 87.
30. In Shawneetown Feed & Seed Co. v. Ford, 468 S.W.2d 54 (St. L. Mo. App. 1971), the alleged partner owned a part of the building involved, worked full time, and wrote checks on the business account to pay the bills. Yet the court found no partnership. The *Grissum* court did not directly distinguish *Shawneetown* but the fact that the parties involved were husband and wife probably provided a sufficient motive for their behavior. Thus their conduct did not necessarily imply partnership intent. The brother and sister relation is not comparable because no obligation to support Nora can be imputed to Elwood.
31. Bevan v. Hill, 262 S.W. 416, 418 (K.C. Mo. App. 1924).
32. Jones v. Bruce, 211 S.W. 692, 693 (K.C. Mo. App. 1919).
33. Prasse v. Prasse, 77 S.W.2d 1001, 1005 (Mo. 1934).
34. 505 S.W.2d at 86.
35. *Id.*

will be taken into account when the court interprets their intentions from past actions. The same holds true when the court measures the sufficiency of the evidence.

The decision in *Grissum* reflects the court's desire to clarify the factors to be examined when one seeks to imply a partnership. Its obvious impact is to liberalize the requirement of showing the "partners' " intentions by allowing parties to show a right to share profits rather than an actual division. Whether many situations will arise where the courts will find such a right remains an open question. The standard of proof set out in *Grissum* has a less predictable influence on the law. Such formulas are at best only guidelines, and each subsequent case will probably be decided on its own particular facts. The end result of *Grissum* is that both creditors and aggrieved partners should find it easier to show a partnership in Missouri.

THOMAS R. JAYNE

PROMISSORY ESTOPPEL—THE BASIS OF A CAUSE OF ACTION WHICH IS NEITHER CONTRACT, TORT OR QUASI-CONTRACT

Debron Corp. v. National Homes Construction Corp.[1]

Debron, a general contractor planning to bid on the construction of a new building, sought bids from several subcontractors for fabrication and erection of the structural steel. National Homes, the only subcontractor to submit a bid, telephoned a bid for $128 per ton for the erection of the structural steel and $14 per hundred square feet for the steel deck. It was orally agreed that Debron would use this bid in computing its own bid, and that if Debron were awarded the primary contract, National Homes would be the steel erection subcontractor. After Debron was declared low bidder, National Homes continued to pursue the project and continually assured Debron of its intent to do the job.[2] Debron ordered the steel, provided two performance bonds, and made contracts with painters and laborers under the assumption that National Homes would perform. National Homes then advised Debron that it would not perform any work on the project. Debron nevertheless sent National Homes a formal purchase order using the unit price quotations agreed upon. The total price was less than previously specified, however, because fewer tons of steel were required than had been estimated.[3] In addition, the back of the purchase order contained eleven terms and conditions not previously discussed with the National Homes representative.[4] National Homes did not sign this purchase order, and did not perform any work on the project. Debron had another subcontractor erect the steel, at a cost of $97,691.00 over National Homes' bid.[5]

Debron brought suit against National Homes solely on the theory of "promissory estoppel."[6] A count for breach of contract had

1. 493 F.2d 352 (8th Cir. 1974).

2. This was evidenced by National's meetings with the owners, and by communications and meetings with Debron. *Id.* at 354, 355.

3. National's total price bid was $495,608. The price on the purchase order was $8,746 less than National's bid. *Id.* at 355.

4. The new terms and conditions were standard clauses. *Id.* at 359.

5. *Id.* at 355.

6. The term "promissory estoppel" is used by the majority of courts to denote the doctrine expressed in the Restatement of Contracts § 90 (1932). This section provides that:

> A promise which the promisor should reasonably expect to induce action or forbearance of a definite and substantial character on the part of the promisee and which does induce such action or forbearance is binding if injustice can be avoided only by enforcement of the promise.

been voluntarily dismissed by Debron prior to trial. The jury returned a verdict for plaintiff in the amount of $97,691, but the trial court granted judgment for defendant notwithstanding the verdict on the ground that Debron had not met its burden of proving reliance on the original bid.[7] The court of appeals, applying Missouri law, reversed and remanded with instructions to reinstate the verdict for plaintiff, finding that plaintiff's use of defendant's bid and preparations for performance constituted reliance which would justify the verdict. The court of appeals held that promissory estoppel can be the basis of a separate cause of action, and that not all of the elements necessary under a contract action are essential to such an action.[8]

The prerequisites for promissory estoppel are: (1) A promise which the promisor should have reasonably expected to induce action or forbearance of a definite and substantial character on the part of the promisee, (2) actual inducement of such action or forbearance, and (3) an injustice which can be avoided only by enforcement of the promise.[9]

The doctrine of promissory estoppel was initally rejected in commercial transactions.[10] Courts felt that a promise made to induce a counter-promise or other consideration was not enforceable until the bargained for consideration was received.[11] The Restatement of Contracts, Section 90, however, does not attempt to so restrict the doctrine. Indeed, the modern trend is not to limit the doctrine's application, but to expand the doctrine to any promise which meets its requirements.[12] In construction bid cases similar to *Debron* the doctrine has been construed broadly. The majority of courts have applied the doctrine of promissory estoppel, holding that the general contractor's reliance renders the subcontractor's offer irrevocable for a reasonable period of time.[13] The doctrine of

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In explaining this doctrine, the American Law Institute avoided use of the phrase "promissory estoppel." The phrase has been criticised as inaccurate because of these various other usages of the word "estoppel." 1A Corbin, Contracts § 204 (1963).

7. Debron Corp. v. National Homes Constr. Corp., 362 F. Supp. 341 (E.D. Mo. 1973).

8. 493 F.2d at 357, 358.

9. Restatement of Contracts § 90 (1932). *See also* Boyer, *Promissory Estoppel: Requirements and Limitations of the Doctrine*, 98 U. Pa. L. Rev. 459 (1950).

10. James Baird Co. v. Gimbel Bros., Inc., 64 F.2d 344 (2d Cir. 1933). *See also* Boyer, *Promissory Estoppel: Principle From Precedents: (pts. I & II)*, 50 Mich. L. Rev. 639, 873 (1952); Henderson, *Promissory Estoppel and Traditional Contract Doctrine*, 78 Yale L. Rev. 343 (1969).

11. James Baird Co. v. Gimbel Bros., Inc., 64 F.2d 344, 346 (2d Cir. 1933).

12. J. Calamari & J. Perillo, Contracts § 106 (1970).

13. Robert Gordon, Inc. v. Ingersoll-Rand Co., 117 F.2d 654 (7th Cir. 1941) (promissory estoppel not applied because promisee failed to show irreparable detriment); Reynolds v.

promissory estoppel has been accepted in Missouri,[14] and as early as 1909 the doctrine was applied to commercial transactions.[15] Thus, *Debron* was only a new application of a doctrine established in Missouri law.[16]

When a promise lacks consideration, but is enforced because the elements of promissory estoppel are met, some courts have viewed the detrimental reliance as a substitute for consideration.[17] Other courts have looked at promissory estoppel as simply making the promise enforceable without consideration.[18] The latter characterization treats the promise as an offer which is made irrevocable by offeree's reliance, and which must be accepted within a reasonable time. Regardless of which approach is used, the net result is an enforceable contract. Promissory estoppel applied in either manner treats the doctrine as an element of the law of contracts.[19]

Debron's significance stems from the plaintiff's use of the doctrine of promissory estoppel as a cause of action which is neither contract, tort or quasi-contract. This approach had been employed in other jurisdictions,[20] but, not in Missouri.

Texarkana Constr. Co., 237 Ark. 583, 375 S.W.2d 818 (1964); Saliba-Kringlen Corp. v. Allen Engineering Co., 15 Cal. App. 3d 95, 92 Cal. Rptr. 799 (1971); H. W. Stanfield Constr. Corp. v. Robert McMullan & Son, Inc., 14 Cal. App. 3d 848, 92 Cal. Rptr. 669 (1971); Norcross v. Winters, 209 Cal. App. 2d 207, 25 Cal. Rptr. 821 (1962); Drennan v. Star Paving Co., 51 Cal. 2d 409, 333 P.2d 757 (1958); E. A. Coronis Associates v. M. Gordon Constr. Co., 90 N.J. Super. 69, 216 A.2d 246 (1966); Northwestern Engineering Co. v. Ellerman, 69 S.D. 397, 10 N.W.2d 879 (1943). *But see* James Baird Co. v. Gimbel Bros., Inc., 64 F.2d 344 (2d Cir. 1933); Southeastern Sales & Service Co. v. T. T. Watson, Inc., 172 So.2d 239 (Fla. Dist. Ct. App. 1965).

14. Pitt v. Gentle, 49 Mo. 74 (1871); School District v. Sheidley, 138 Mo. 672, 40 S.W. 656 (En Banc 1897); In re Jamison's Estate, 362 Mo. 1054, 202 S.W.2d 879 (1947); Feinberg v. Pfeiffer Co., 322 S.W.2d 163 (St. L. Mo. App. 1959). *See also* Bollow, *Promissory Estoppel-Reliance On Mistaken Bid of Subcontractor*, 26 Mo. L. Rev. 356 (1961).

15. Underwood Typewriter Co. v. Century Realty Co., 220 Mo. 522, 119 S.W. 400 (En Banc 1909) (tenant relied on lessor's promise to consent to as assignment of the lease). *Accord*, Aden v. Dalton, 341 Mo. 454, 107 S.W.2d 1070 (1937) (prohibited cancellation of a mining lease after lessor permitted entry on the leased land for exploration).

16. 493 F.2d at 357.

17. *See* Allegheny College v. National Chautauqua County Bank, 246 N.Y. 369, 373, 374, 159 N.E. 173, 175 (1927).

18. *See e.g.*, Drennan v. Star Paving Co., 51 Cal. 2d 409, 333 P.2d 757 (1958).

19. There must still be an acceptance to invoke promissory liability. N. Litterio & Co. v. Glassman Constr. Co., 319 F.2d 736 (D.C. Cir. 1963); R. J. Daum Constr. Co. v. Child, 122 Utah 194, 247 P.2d 817 (1952). In *Daum*, the attempted acceptance was found to be a counter-offer. Because no acceptance had occurred, the court refused to apply the doctrine of promissory estoppel. *Id.* at 208, 247 P.2d at 823. *See also* Navin, *Some Comments on Unilateral Contracts and Restatement 90*, 46 Marq. L. Rev. 162, 168, 169 (1962).

20. Constructors Supply Co. v. Bostrom Sheet Metal Works, Inc., 291 Minn. 113, 190 N.W.2d 71 (1971); Hoffman v. Red Owl Stores, Inc., 26 Wis. 2d 683, 133 N.W.2d 267 (1965). *Compare* Goodman v. Dicker, 169 F.2d 684 (D.C. Cir. 1948). In *Hoffman*, plaintiff relied on

It is not perfectly clear what approach the court of appeals employed in finding for the general contractor.[21] *Debron* could have been decided on a purely contractual basis. The facts would have supported a finding of an offer and an acceptance followed by a revocation. The court said that the offer had been accepted,[22] but it was ambiguous as to when the acceptance actually occurred. Still, the opinion can be construed as recognizing an acceptance by conduct rather than words,[23] before the revocation. The court alluded to an acceptance when it stated that the general contractor promptly informed the subcontractor that he was being awarded the job, and that the subcontractor acted accordingly.[24] This could be regarded as establishing an acceptance.[25] This aspect of the case was not reached, however, because the count for breach of contract had been dismissed by plaintiff before trial.[26]

There are two possible interpretations of the court's reasoning in reaching its decision. First, *Debron* can be regarded as applying promissory estoppel to make a subcontractor's offer irrevocable once the general contractor relies on it. Using this rationale, however, the irrevocable offer must still be accepted within a reasonable time, just as if it was an action in contract. This view, adopted by the

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defendant's promise to grant him a supermarket franchise. Defendant contended that there would be no binding contract even if the promisee were to accept, because his promise lacked the essential factors necessary to establish an offer. The court found for the plaintiff, stating that the promise did not have to meet the requirements of an offer. Hence, the doctrine of promissory estoppel was applied, not as an element of contract law, but as a separate cause of action. This extended the promissory estoppel doctrine further than had most courts at that time. *See* Note, *Contracts: Reliance Losses: Promissory Estoppel as a Basis of Recovery for Breach of Agreement To Agree:*, 51 Cornell L.Q. 351, 355 (1966).

21. In this respect the decision was similar to that in Constructors Supply Co. v. Bostrom Sheet Metal Works, Inc., 291 Minn. 113, 190 N.W.2d 71 (1971) a similar construction bid case cited with approval in *Debron*. The *Bostrom* court found for the general contractor, but it is not clear what approach it used. On one hand, it seems that the court decided that the subcontractor's offer was made irrevocable by the general contractor's reliance. This is implied by the court citation with approval of cases that have so held. *Id.* at 118, 119, 190 N.W.2d at 74, 75. This treats the promissory estoppel doctrine as an element of contract law. On the other hand, it also appears that the court approached the doctrine of promissory estoppel as the basis of a separate cause of action. The court concluded that a cause of action based on promissory estoppel was established, and avoided any reference to an acceptance. *Id.* at 119, 120, 190 N.W.2d at 76. Although the analysis of the court is not clear, *Bostrom* provides some authority for the proposition that promissory estoppel is an appropriate basis for a separate cause of action.

22. 493 F.2d at 358.

23. An acceptance of an offer may be established by conduct as well as by words. *See* Shepard v. Glick, 404 S.W.2d 441 (K.C. Mo. App. 1966); Jacob Dold Packing Plant v. General Box Co., 194 S.W.2d 55 (K.C. Mo. App. 1946).

24. 493 F.2d at 358.

25. *Id.* at 354, 355.

26. *Id.* at 353.

Restatement Second,[27] is supported by the cases cited in *Debron*.[28] It is further buttressed by the court's references to "a binding offer in the form of a promise,"[29] and to its requirement of acceptance within a reasonable time.[30] These statements indicate the use of promissory estoppel to make the offer irrevocable as a principle of contract law.

Second, the *Debron* opinion can be interpreted as applying promissory estoppel as the basis of a non-contractual cause of action. Plaintiff plainly urged this viewpoint when it dismissed its count for breach of contract, and submitted proof solely on the theory of promissory estoppel without reference to a contract. Using this approach, the cause of action has only the three requirements of promissory estoppel.[31] The traditional contract principles of offer and acceptance are not necessary. The court concluded that the necessary requirements for promissory estoppel were met in *Debron*.[32] The court's assertion that the events after the subcontractor's revocation were irrelevant indicates that it was employing promissory estoppel as a separate cause of action.[33] This suggests that an acceptance or counter-offer (traditional contract concepts) would not determine whether substantial detriment had been induced by the subcontractor's promise. The court, however, strayed from this approach by discussing the necessity of acceptance within a reasonable time and the question of whether there had been a

27. Restatement (Second) of Contracts § 89(B)(2) (Tent. Drafts Nos. 1-7, 1973) reads:

> An offer which the offeror should reasonably expect to induce action or forbearance of a substantial character on the part of the offeree before acceptance and which does induce such action or forbearance is binding as an option contract to the extent necessary to avoid injustice.

Illustration No. 6 under this section provides:

> A submits a written offer for paving work to be used by B as a partial basis for B's bid as general contractor on a large building. As A knows, B is required to name his subcontractors in his general bid. B uses A's offer and B's bid is accepted. A's offer is irrevocable until B has had a reasonable opportunity to notify A of the award and B's acceptance of A's offer.

28. *E.g.*, Reynolds v. Texarkana Constr. Co., 237 Ark. 583, 374 S.W.2d 818 (1964); Drennan v. Star Paving Co., 51 Cal. 2d 409, 333 P.2d 757 (1958); Northwestern Engineering Co. v. Ellerman, 69 S.D. 397, 10 N.W.2d 879 (1943).

29. 493 F.2d at 357.

30. *Id.* at 358.

31. *See* text accompanying note 9 *supra*.

32. The court found that the facts showed a sufficient promise by the subcontractor, made with a reasonable expectation of inducing action of a definite and substantial character on the part of the general contractor. 493 F.2d at 357. This promise did induce such action on the part of the general contractor, and substantial injustice would occur without enforcement of the promise. 493 F.2d at 358.

33. *Id.* at 358.

counter-offer.[34] Nevertheless, *Debron* does state that a cause of action based on promissory estoppel alone is appropriate for commercial transactions in Missouri. The cause of action brought by the plaintiff was not one in contract, tort or quasi-contract, but was based on promissory estoppel, and the general contractor was successful.

In many cases, it would be appropriate to apply promissory estoppel to create enforceable contracts, by making offers irrevocable once they are relied on.[35] This approach would fail, however, in those cases that lack an offer or an acceptance. In cases that do not meet the requirements of contract law, the separate cause of action based on promissory estoppel should be used to prevent unjust results. This modern trend in the liberalization of the promissory estoppel doctrine is an exception to traditional contract principles, and its progressive use may be expected to set a course for the future.[36] Such use of the promissory estoppel doctrine should be encouraged, especially when it is necessary to a just result.

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34. *Id.* at 359.

35. In most cases promissory estoppel is contractually invoked to enforce a subcontractor's bid to a general contractor, but it should be pointed out that promissory estoppel is also available to subcontractors. Use of the promissory estoppel doctrine, by the subcontractor, would help eliminate "bid shopping." "Bid shopping" occurs when the general contractor, after being awarded the main contract, uses the low bid already received from the subcontractor in order to pressure others to submit even lower bids. Many times, the original subcontractor will lower his own bid, in an effort to keep from losing the subcontract to another. *See generally* Gaides, *The "Firm Offer" Problem In Construction Bids And The Need For Promissory Estoppel*, 10 Wm. & Mary L. Rev. 212 (1968); Schultz, *The Firm Offer Puzzle: A Study of Business Practice In The Construction Industry*, 19 U. Chi. L. Rev. 237 (1952).

36. J. Calamari & J. Perillo, Contracts §§ 108, 111 (1970).

SECURED TRANSACTIONS: NONCOMPLIANCE WITH THE UNIFORM COMMERCIAL CODE'S RESALE PROVISIONS AND THE SECURED PARTY'S RIGHT TO A DEFICIENCY JUDGMENT

Wirth v. Heavey[1]

Edward and Charlotte Wirth, payees of a note and secured parties under a security agreement, brought this action for a deficiency judgment against the debtors, James and Gloria Heavey.[2] The note being in default, the Wirths made demand upon the Heaveys for the total balance due and concurrently gave notice of their intent to hold a private sale of the collateral described in the security agreement. The Wirths rejected a subsequent tender of the late payment and solicited bids through the newspaper with the following results: (1) bids of $350 and $310 for two refrigerated root beer barrels, and (2) bids of $500, $450, $400 and $150 for all of the equipment.[3] The Wirths displayed the collateral to the interested parties and then purchased it themselves for $650, reselling the two root beer barrels to the $350 bidder.

Relying on Uniform Commercial Code Sections 9-504(3) and 9-507(1),[4] the defendant answered alleging "certain irregularities in the disposition of the collateral"[5] and further contending that the plaintiffs should be denied a deficiency judgment. The circuit court found that the private sale of the collateral was in conformity with Section 9-504(3) and entered judgment for the plaintiffs.[6] The court of appeals reversed the lower court's determination of compliance with the Code, but affirmed the deficiency judgment.

Upon default of the debtor, the secured party's right to dispose of the collateral by sale or other disposition[7] is regulated by Uniform

1. 508 S.W.2d 263 (Mo. App., D.K.C. 1974).

2. *Id.* at 264. The action against James Heavey was subsequently dismissed with prejudice after the underlying debt was discharged in bankruptcy. The Wirths and Heaveys were formerly partners in a Mugs-Up Root Beer Drive-In operation. Plaintiffs sold their interest in the business to the Heaveys for $4,000 and took a security interest in the business equipment.

3. *Id.*

4. Unless otherwise indicated, all section references are to the UNIFORM COMMERCIAL CODE (1962). Sections 400.1-101-400.10-102, RSMo 1969, correspond to the UNIFORM COMMERCIAL CODE (1962) except for variations and alternatives, noted where applicable.

5. 508 S.W.2d at 265.

6. *Id.* The court determined the deficiency to be $3,317.79, after crediting the note for $650, and interest and attorney's fees. A further credit of $134 was allowed from the sale of non-secured inventory and judgment was entered for $3,083.77 [*sic*].

7. UNIFORM COMMERCIAL CODE § 9-504(1), allows a secured party to "sell, lease or otherwise dispose" of the collateral. In addition, the secured party has available alternative remedies. *See Id.* §§ 9-501(1), 9-505 and Comments.

Commercial Code Section 9-504. The principle limitations upon the secured party's conduct are those of good faith[8] and commercial reasonableness.[9] A more specific limitation prohibits the secured party from purchasing at private sale unless " . . . the collateral is of a type customarily sold in a recognized market or is of a type which is the subject of widely distributed standard price quotations . . . ."[10] Where the sale of the collateral results in a price less than the total balance due, Section 9-504(2) renders the debtor liable for the deficiency.

Under Section 9-507(1), noncompliance with the provisions of the Code governing conduct after default makes the secured party liable for "any loss" incurred by the debtor.[11] The purpose of this provision is to safeguard the debtor's interests through judicial restraint of attempts to unreasonably dispose of the collateral, or awarding damages if the disposition has already occured.[12] While this Section provides the debtor with an affirmative cause of action, its applicability to a deficiency suit setting is not defined in the Code.[13]

The cases are hopelessly split on the issue of whether denial of a deficiency to a secured party is permissible under the Code. In nearly all of the cases, the noncomplying acts are violations of the notice provision.[14] A majority[15] of these cases, led by *Skeels v. Uni-*

8. UNIFORM COMMERCIAL CODE § 1-203, provides: Every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement.

9. UNIFORM COMMERCIAL CODE § 9-504(3) provides that "every aspect of the disposition . . . must be commercially reasonable." The purpose of these generalized precepts is to provide a greater realization for the mutual benefit of the parties. *See* O. SPIVACK, SECURED TRANSACTIONS (UNDER THE UNIFORM COMMERCIAL CODE) 133 (3d ed. 1963); Gilmore, *Article 9 of the Uniform Commercial Code-Part V Default*, 7 CONF. ON PER. FIN. L.Q. 4, 7 (1952).

10. UNIFORM COMMERCIAL CODE § 9-504(3).

11. This Section also provides that the secured party's liability may extend beyond the debtor to include any person entitled to notification or any person whose security interest is made known prior to disposition. A further proviso allows for a minimum statutory penalty in the case of consumer goods.

12. UNIFORM COMMERCIAL CODE § 9-507(1) and Comment 1. *See* Hogan, *The Secured Party and Default Proceedings Under the UCC*, 47 MINN. L. REV. 205, 207 (1962).

13. It has been suggested that this situation was not considered by the Article 9 draftsmen. *See* 2 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 44.9.4, at 1264 (1965).

14. UNIFORM COMMERCIAL CODE § 9-504(3). The basic premise is for "reasonable notification" with variations for implementation depending on the type of collateral, method of disposition, and existence of other secured parties.

15. Braswell v. American Nat'l Bank, 117 Ga. App. 699, 701, 161 S.E.2d 420, 422 (1968); Comment, *Remedies For Failure to Notify Debtor of Disposition of Repossessed Collateral Under the UCC*, 44 U. COLO. L. REV. 221 (1972); Comment, *Article 9-Notice Provisions Upon Default*, 1972 WASH. U. L. Q. 535, 552. *But see* J. WHITE & R. SUMMERS, UNIFORM COMMERCIAL CODE § 26-15, at 1002 (1972).

versal C.I.T. Credit Corp.,[16] hold that compliance with the Code is a condition precedent to recovery of a deficiency.[17] The primary justifications for denying a deficiency are: (1) it operates as a deterrent to the secured party's noncompliance;[18] (2) the debtor has lost his opportunity to redeem,[19] therefore the secured party should lose his right to a deficiency judgment;[20] (3) lack of notice prevents the debtor from being present at the sale in order to insure a proper sale and protect his equity;[21] (4) under pre-Code case law,[22] most courts denied a deficiency;[23] and (5) Section 9-507 is not expressly made an exclusive remedy.[24] In essence, these courts have establihsed that

16. 222 F. Supp. 696 (W.D. Pa. 1963), *rev'd on other grounds*, 335 F.2d 846 (3d Cir. 1964).

17. *In re* Bro Cliff, Inc., 8 UCC REP. SERV. 1144 (W.D. Mich. 1971); Edmondson v. Air Serv. Co., 123 Ga. App. 263, 180 S.E.2d 589 (1971); C.I.T. Corp. v. Haynes, 161 Me. 353, 212 A.2d 436 (1965); One Twenty Credit Union v. Darcy, 40 Mass. App. Dec. 64 (Boston Mun. Ct. 1968); Cities Serv. Oil Co. v. Ferris, 9 UCC REP. SERV. 899 (Mich. Dist. Ct. 1971); Foundation Discounts, Inc. v. Serna, 81 N.M. 474, 468 P.2d 875 (1970); Crosby v. Basin Motor Co., 83 N.M. 77, 488 P.2d 127 (Ct. App. 1971); and cases cited notes 18-24 *infra*.

18. Associates Discount Corp. v. Cary, 47 Misc. 2d 369, 262 N.Y.S.2d 646 (N.Y. City Ct. 1965); Comment, *The Right to an Article 9 Deficiency Judgment Without 9-504 Notice of Resale*, 7 VAL. U. L. REV. 465, 471 (1973); *cf.* Posel, *Sales and Sales Financing*, 16 RUTGERS L. REV. 329, 345 (1962)(pre-Code case law).

19. UNIFORM COMMERCIAL CODE § 9-506 specifies the manner and circumstances in which the debtor has the right of redemption.

20. Skeels v. Universal C.I.T. Credit Corp., 222 F. Supp. 696, 702 (W.D. Pa. 1963), *rev'd on other grounds*, 335 F.2d 846 (3d Cir. 1964); Atlas Thrift Co. v. Horan, 27 Cal. App. 3d 999, 1007, 104 Cal. Rptr. 315, 320 (1972)(California has modified § 9-504(3) by adding more specificity to the notice requirement); Morris Plan Co. v. Johnson, 133 Ill. App. 2d 717, 721, 271 N.E.2d 404, 407 (1971). *See also* Cox Motor Car Co. v. Castle, 402 S.W.2d 429, 432 (Ky. App. 1966). *Cf.* note 47 *infra*.

21. Skeels v. Universal C.I.T. Credit Corp., 222 F. Supp. 696, 702 (W.D. Pa. 1963), *rev'd on other grounds*, 335 F.2d 846 (3d Cir. 1964); *see* Morris Plan Co. v. Johnson, 133 Ill. App. 2d 717, 721, 271 N.E.2d 404, 407 (1971).

22. Atlas Thrift Co. v. Horan, 27 Cal. App. 3d 999, 1008, 104 Cal. Rptr. 315, 321 (1972); Leasco Data Processing Equip. Corp. v. Atlas Shirt Co., 66 Misc. 2d 1089, 1090, 323 N.Y.S.2d 13, 15 (Civ. Ct. 1971); 2 G. GILMORE, *supra* note 13, § 44.9.4, at 1262, 1263; J. WHITE & R. SUMMERS, *supra* note 15, § 26-15, at 1000. *Contra*, Abbott Motors, Inc. v. Ralston, 28 Mass. App. Dec. 35, 39 (Dist. Ct. 1964)(not followed in One Twenty Credit Union v. Darcy, 40 Mass. App. Dec. 64 (Boston Mun. Ct. 1968)); Conti Causeway Ford v. Jarossy, 114 N.J. Super. 382, 386, 276 A.2d 402, 404 (Dist. Ct. 1971).

23. Annot., 49 A.L.R.2d 15, § 24, at 82 (1956).

24. Atlas Thrift Co. v. Horan, 27 Cal. App. 3d 999, 1008, 104 Cal. Rptr. 315, 321 (1972); Leasco Data Processing Equip. Corp. v. Atlas Shirt Co., 66 Misc. 2d 1089, 1091, 323 N.Y.S.2d 13, 16 (Civ. Ct. 1971); 2 G. GILMORE, *supra* note 13, § 44.9.4, at 1264. *See generally* J. WHITE & R. SUMMERS, *supra* note 15, § 26-15, at 1000; Comment, *Denial of Deficiency: A Problem of Reasonable Notice Under UCC § 9-504(3)*, 34 OHIO ST. L.J. 657, 661-668 (1973). *Contra*, Mercantile Fin. Corp. v. Miller, 292 F. Supp. 797, 801 (E.D. Pa. 1968); Simon v. Central Nat'l Bank, 243 So. 2d 634, 635 (Fla. App. 1971)(substantial compliance with the notice provision is sufficient); Grant County Tractor Co. v. Nuss, 6 Wash. App. 866, 870, 496 P.2d 966, 969 (1972). "The sensible thing is to apply the Code penalty and no more." Hogan, *Pitfalls in*

noncompliance with the notice provision is a defense available to the debtor to bar the secured party's recovery of any deficiency judgment.

This flat denial of any deficiency, particularly in light of the Code's express provision allowing the debtor to recover "any loss" precipitated by the secured party's misconduct,[25] was unacceptable to many courts. In *Mercantile Financial Corp. v. Miller*[26] the court held Section 9-507(1) specifically provides the debtor with an affirmative cause of action for damages (or as a set-off in a deficiency suit) and that the drafters of the Code did not intend to deny the secured party a deficiency as an additional penalty.[27] The burden of proof was placed on the debtor to establish the extent of his losses.[28]

In *Norton v. National Bank of Commerce*,[29] the Arkansas Supreme Court employed the same rationale as that subsequently used in *Miller* to deny application of the *Skeels* rule.[30] In contrast with *Miller*, however, the *Norton* court went on to say:

> [S]imple considerations of fair play cast the *burden of proof upon the [secured party]* . . . . We think the just solution is to indulge the presumption in the first instance that the collateral was worth at least the amount of the debt, thereby shifting to the creditor the burden of proving the amount that should reasonably have been obtained through a sale conducted according to law.[31]

The hybrid approach of *Norton* results from a reluctance to

Default Procedure, 86 BANK. L.J. 965, 978 (1969).

Other justifications have also been advanced. An interesting Georgia trilogy of cases initially denied the secured party a deficiency on the basis of accord and satisfaction, which rationale eventually evolved into denial of any deficiency based on interpretation of the Code. Moody v. Nides Fin. Co., 115 Ga. App. 859, 156 S.E.2d 310 (1967); Johnson v. Commercial Credit Corp., 117 Ga. App. 131, 159 S.E.2d 290 (1968); Braswell v. American Nat'l Bank, 117 Ga. App. 699, 161 S.E.2d 420 (1968).

25. *See* note 11 *supra* and accompanying text.

26. 292 F. Supp. 797 (E.D. Pa. 1968).

27. *Id.* at 801. Abbott Motors, Inc. v. Ralston, 28 Mass. App. Dec. 35, 39 (Dist. Ct. 1964)(not followed in One Twenty Credit Union v. Darcy, 40 Mass. App. Dec. 64 (Boston Mun. Ct. 1968)); Grant County Tractor Co. v. Nuss, 6 Wash. App. 866, 870, 496 P.2d 966, 969 (1972).

28. Cases cited note 27 *supra*. 2 W. HAWKLAND, A TRANSACTIONAL GUIDE TO THE UNIFORM COMMERCIAL CODE § 2.3009, at 670 (1964), wherein the author states " . . . the injured party is entitled only to the damages he can prove."

29. 240 Ark. 143, 398 S.W.2d 538 (1966).

30. *Id.* at 149, 398 S.W.2d at 542. The court reasoned that § 9-504(2) gives the secured party the right to a deficiency and that § 9-507(1), being the debtor's exclusive remedy for any loss created by the secured party's misconduct, did not automatically terminate that right.

31. 240 Ark. at 150, 398 S.W.2d at 542 (emphasis added).

impose a difficult burden of proof on the debtor.[32] It has been adopted by many courts.[33] Other rationales advanced in support of the *Norton* rule are: (1) the secured party's deficiency may not necessarily correspond to the amount of the debtor's damages;[34] (2) penal damages are disfavored in the Code[35] and imposition of an additional penalty in addition to that prescribed in section 9-507(1) is unwarranted;[36] and (3) the Code's emphasis on flexibility precludes operation of stringent pre-Code case law,[37] thereby leaving room for "honest error."[38] Although the *Norton* rule reads into the Code a rebuttable presumption that the collateral was worth at least the amount of the debt, the secured party may still recover a deficiency if he can successfully demonstrate that the reasonable value of the collateral was less than the outstanding debt.[39]

In the absence of Missouri precedent and in reliance on section 9-507(1) as the debtor's exclusive remedy, the court in *Wirth* rejected the *Skeels* rule and adopted the *Norton* standard as a "more just remedy."[40] It has been suggested that *Norton* was unclear as to the specific requirements to be met in order to allow the secured party to recover a deficiency.[41] This uncertainty, coupled with the

32. *Id.* The court stated the secured party's wrongful disposition of the collateral without notice " . . . made it at least difficult, if not impossible, for [the debtor] to prove the extent of his loss with reasonable certainty."

33. Weaver v. O'Meara Motor Co., 452 P.2d 87 (Alas. 1969); Carter v. Ryburn Ford Sales, Inc., 248 Ark. 236, 451 S.W.2d 199 (1970); Barker v. Horn, 245 Ark. 315, 432 S.W.2d 21 (1968); T & W Ice Cream, Inc., v. Carriage Barn, Inc., 107 N.J. Super. 328, 258 A.2d 162 (L. Div. 1969); Lincoln Rochester Trust Co. v. Howard, 75 Misc. 2d 181, 347 N.Y.S.2d 306 (Rochester City Ct. 1973); Mallicoat v. Volunteer Fin. & Loan Corp., 57 Tenn. App. 106, 415 S.W.2d 347 (1966); and cases cited notes 34-39 *infra*.

34. Comment, *Denial of Deficiency: A Problem of Reasonable Notice Under UCC § 9-504(3), supra* note 24, at 662; *e.g.*, Conti Causeway Ford v. Jarossy, 114 N.J. Super. 382, 386, 276 A.2d 402, 404 (1971).

35. UNIFORM COMMERCIAL CODE § 1-106(1) and Comment 1.

36. Hogan, *Pitfalls in Default Procedure, supra* note 24. *See also* Conti Causeway Ford v. Jarossy, 114 N.J. Super. 382, 386, 276 A.2d 402, 404 (1971); Posel, *Sales and Sales Financing, supra* note 18, at 346.

37. Annot., 49 A.L.R.2d 15, § 24, at 82 (1956).

38. Note, *Secured Transactions - Tortious Repossession of Inventory - Right of Debtor to Receive Notice of Disposition of Repossessed Collateral Under Uniform Commercial Code - Skeels v. Universal C.I.T. Credit Corp.*, 5 B.C. IND. & COM. L. REV. 831, 836 (1964). *See* Conti Causeway Ford v. Jarossy, 114 N.J. Super. 382, 385, 276 A.2d 402, 404 (1971); *cf.* UNIFORM COMMERCIAL CODE § 9-504, Comment 1.

39. Universal C.I.T. Credit Co. v. Rone, 248 Ark. 665, 669, 453 S.W.2d 37, 39 (1970); Carter v. Ryburn Ford Sales, Inc., 248 Ark. 236, 451 S.W.2d 199 (1970); J. WHITE & R. SUMMERS, *supra* note 15, § 26-15, at 1004.

40. 508 S.W.2d at 268.

41. J. WHITE & R. SUMMERS, *supra* note 15, § 26-15, at 1004; Comment, *Remedies For Failure to Notify Debtor of Disposition of Repossessed Collateral Under the UCC, supra* note 15, at 231.

fact that in many cases the secured party has failed to rebut the presumption,[42] has led to some skepticism that the *Norton* presumption has really not brought about any change from the earlier *Skeels* rule.[43] By holding that the secured party rebutted the presumption, *Wirth* adds viability to *Norton*, although it fails to explain what kind of evidence the creditor must introduce to meet his burden or proof.[44]

A distinction, however, may be drawn between the facts of *Skeels*, *Norton*, and *Wirth*. In *Skeels* and *Norton*, the noncomplying act was violation of the notice provision,[45] whereas *Wirth* was *not* a notice case, but rather concerned a secured party's purchase at a private sale in violation of Section 9-504(3).[46] In light of this distinction, a two part analysis should be employed to determine the applicability of Section 9-507(1) to the deficiency suit. First, should the court adopt the *Skeels* rule and deny the secured party a deficiency? When the sole violation is a wrongful creditor purchase, several of the justifications for the *Skeels* rule are not present. The debtor in Wirth was provided with proper notice, thereby affording him an opportunity to redeem[47] and protect his equity.[48] Also, pervading many of these cases is an unarticulated and undenominated concept of fair play.[49] Fair play was apparently a motivating force in the

42. *E.g.*, Gallatin Trust & Savings Bank v. Darrah, 152 Mont. 256, 448 P.2d 734 (1968); T & W Ice Cream, Inc. v. Carriage Barn, Inc., 107 N.J. Super. 328, 258 A.2d 162 (L. Div. 1969); Mallicoat v. Volunteer Fin. & Loan Corp., 57 Tenn. App. 106, 415 S.W.2d 347 (1966).

43. J. WHITE & R. SUMMERS, *supra* note 15, § 26-15, at 1006.

44. 508 S.W.2d at 269. The evidence considered by the court included the conflicting testimony of the parties, the cost of much of the equipment in an used condition several years before, that the note was given in part for the Wirth's interest in an ongoing business, and presumably the bids received. *See also*, Weaver v. O'Meara Motor Co., 452 P.2d 87, 92 n.17 (Alas. 1969) (presumption rebutted where secured party introduced evidence of bid solicitations from a four state area and depositions of two appraisers); *cf.* T & W Ice Cream, Inc. v. Carriage Barn, Inc., 107 N.J. Super. 328, 336, 337, 258 A.2d 162, 167 (L. Div. 1969)(secured party's testimony that he had contacted nondealer with regards to value of the collateral was insufficient to rebut presumption).

45. *See* notes 16 and 32 *supra*.

46. *See* note 10 *supra* and accompanying text. It would appear that the rationale for denying the secured party the opportunity to purchase the collateral at private sale is founded on the notion that the secured party's interests are diametrically opposed to those of the debtor in this situation. The drafters of the Code did allow for the above two exceptions, but in these situations violations of the debtor's interests, in terms of price, should be readily ascertainable.

47. *See* note 19 *supra* and accompanying text. Furthermore, there is some authority for the proposition that the debtor's right to redeem continues after the sale in cases of wrongful creditor purchase. 2 G. GILMORE, *supra* note 13, at 1255; Hogan, *The Secured Party and Default Proceedings Under the UCC*, *supra* note 12, at 241.

48. *See* note 21 *supra* and accompanying text.

49. *E.g.*, Skeels v. Universal C.I.T. Credit Corp., 222 F. Supp. 696 (W.D. Pa. 1963), *rev'd on other grounds*, 335 F.2d 846, 851 (3d Cir. 1964)(wherein the court states ". . . a jury could not easily avoid the conclusion that it would be grossly improper and inconsistent with

Wirth decision.[50]

If the *Skeels* rule is rejected as it was in *Norton* and *Wirth*, the court must then determine whether the debtor should bear the burden of proving his loss. The violation's practical effect upon the burden of proof should be considered. In *Norton*, the basis for shifting the burden of proof to the secured party was the fact that without notice the collateral could be moved a great distance before the debtor even learned of its sale. Thus, according to the *Norton* court, the noncomplying secured party would be benefited by his own misconduct and an onerous burden would be placed on the debtor.[51] In *Wirth*, however, the debtor had received proper notice[52] and, if anything, the secured party's wrongful purchase inhibited escape of the collateral. The court in *Wirth* may have failed to perceive this subtle distinction.[53] Section 9-507(1) contemplates an affirmative cause of action with the burden of proof on the debtor.[54] Accordingly, unless there is strong justification for shifting the burden to the secured party (for example, where the notice provision is violated), it should remain on the debtor.[55]

The precise nature of, and circumstances surrounding, the violation should be the critical factors in determining the applicability of Uniform Commercial Code § 9-507(1) to a deficiency suit. The notice cases provide an excellent reference point but should not necessarily be controlling for all violations of the Article 9, Part V resale provisions.

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good faith dealing . . . ."); Norton v. National Bank of Commerce, 240 Ark. 143, 150, 398 S.W.2d 538, 542 (1966)(wherein the court states " . . . simple considerations of fair play cast the burden of proof upon the bank."); *cf.* 4 R. ANDERSON, UNIFORM COMMERCIAL CODE § 9-507:6, at 645 (2d ed. 1971).

50. 508 S.W.2d at 268. Referring to forfeiture of a deficiency, the court states, "Such a sanction, however, does not suit the circumstances of this case. What appears to be a more just remedy . . . was expressed . . . in Norton . . . ."

51. 240 Ark. at 150, 398 S.W.2d at 542.

52. 508 S.W.2d at 264.

53. This, however, is not an uncommon occurence. *E.g.*, Carter v. Ryburn Ford Sales, Inc., 248 Ark. 236, 451 S.W.2d 199 (1970). Indeed, many commentators have blindly applied the *Norton* rule across the board to include all violations of Article 9, Part V. *E.g.*, Note, *Uniform Commercial Code - Disposition of Collateral*, ' 20 ARK. L. REV. 385 (1967).

54. Cases cited note 27 *supra*; 2 W. HAWKLAND, *supra* note 28; Comment, *Remedies For Failure to Notify Debtor of Disposition of Repossessed Collateral Under the UCC, supra* note 15, at 227, Comment, *Creditor's Deficiency Judgment Under Article 9 of the Uniform Commercial Code: Effect of Lack of Notice and a Commercially Reasonable Sale*, 33 MD. L. REV. 327, 340 (1973), *cf.* Hogan, *The Secured Party and Default Proceedings Under the UCC, supra* note 12, at 240, 241.

55. The anomaly of the court's application of *Norton* is that in essence the court has imposed a penalty upon the secured party which is one of the very issues the *Norton* line of cases presented in denying application of the *Skeels* rule. *See* notes 35, 36 *supra*.

TAXATION—CHALLENGING AN I.R.S. RULING: THE ANTI-INJUNCTION ACT STRICTLY APPLIED TO CHARITABLE ORGANIZATIONS

Bob Jones University v. Simon[1]
and
Alexander v. "Americans United" Inc.[2]

Bob Jones University is a fundamentalist religious institution. The fundamentalists believe that God intended the segregation of the races and that miscegenation is forbidden by the Bible. In obedience to this principle, the University concededly prohibits the admission of Negroes. In a ruling letter of April 30, 1942,[3] the University was granted tax-exempt status[4] as a religious and educational organization under what is currently section 501 of the Internal Revenue Code of 1954.[5] Tax-exempt status is important because it exempts the University from the income tax, and makes contributions[6] to the University tax-deductible.[7] In 1970, the Internal Reve-

1. ___ U.S. ___, 94 S.Ct. 2038 (1974).
2. ___ U.S. ___, 94 S.Ct. 2053 (1974).
3. Apparently the University enjoyed tax-exempt status since its founding in 1926. However, the earliest record of such status is an Internal Revenue Service letter dated March 30, 1951, which refers to a similar ruling letter dated April 30, 1942. *See* Bob Jones Univ. v. Connally, 341 F. Supp. 277, 279 (D.S.C. 1971), *rev'd*, ___ U.S. ___, 94 S.Ct. 2038 (1974).
4. § INT. REV. CODE OF 1954 501(a) exempts §§ 501(c)(3) organizations from federal income tax. Section 501(c)(3) organizations are also exempted by the INT. REV. CODE OF 1954, § 3121(b)(8)(B) from paying federal social security taxes and by the INT. REV. CODE OF 1954, § 3306(c)(8) from paying federal unemployment taxes.
5. INT. REV. CODE OF 1954, § 501(c)(3). Section 501(c)(3) provides that included in the list of exempt organizations are:

> Corporations and any community chest, fund, or foundation organized and operated exclusively for religious, charitable, scientific, testing for public safety, literacy, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to influence legislation, and which does not participate in or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.

6. An institution may apply to the Internal Revenue Service for a ruling as to its tax-exempt status. If an institution qualifies to receive tax-deductible contributions, then the institution will receive a ruling letter stating that it meets the requirements of § 501(c)(3) and § 170(c)(2). *See* Rev. Proc. 72-3, 72-4, 1972-1 CUM. BULL. 698, 706. Receipt of such letter (commonly referred to as an advance assurance of deductibility of contributions) normally means that the organization will be placed on the Service's *Cumulative List (Cumulative List of Organizations described in Section 170 (c) of the Internatl Revenue Code of 1954)* of tax-exempt organizations. This listing is periodically updated and issued as *Publication No. 78* of the Internal Revenue Service. *See* Rev. Proc. 72-39, 1972—2 CUM. BULL. 818. Inclusion in the *Cumulative List* is essential to a successful fund-raising effort by organizations such as Bob Jones University because many donors will not contribute unless the organization is

nue Service (hereinafter referred to as the Service) announced that private schools who have racially discriminatory admission policies would no longer be granted tax-exempt status.[8] After receiving a letter of inquiry as to admissions policies during 1970 and after conducting extensive discussions and conferences with the Service during 1971, Bob Jones University concluded that revocation of its tax-exempt status appeared imminent.

Thereupon, the University filed suit in the Federal District Court of South Carolina and requested injunctive relief from the revocation of its tax-exempt status. The University alleged that the Commissioner's actions were contrary to the provisions of the Internal Revenue Code, would cause irreparable harm in the form of decreased contributions, and would violate its constitutional rights under the first and fifth amendments.[9] The Commissioner moved to dismiss for lack of subject-matter jurisdiction on the basis of the Anti-Injunction Act, section 7421(a) of the Internal Revenue Code of 1954.[10] The District Court of South Carolina denied the motion

among those enumerated in the *Cumulative List*. *See* Bob Jones Univ. v. Simon, ___ U.S. ___, 94 S.Ct. 2038, 2042 (1974).

7. INT. REV. CODE OF 1954, § 170(a)(1) and (c)(2). Section 170(a)(1) states that "[T]here shall be allowed as a deduction any charitable contribution (as defined in subsection (c)) payment of which is made within the taxable year." Section 170(c)(2) defines a charitable contribution as a contribution or gift to or for the use of:

> A corporation, trust, or community chest fund, or foundation—
> (A) created or organized in the United States or in any possession thereof, or under the law of the United States, any state or territory, the District of Columbia, or any possession of the United States;
> (B) organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes or for the prevention of cruelty to children or animals;
> (C) no part of the net earnings of which inures to the benefit of any public shareholder or individual; and
> (D) no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to influence legislation.

Similar deductions for donations to § 501(c)(3) organizations are provided for federal gift and estate tax purposes. *See* INT. REV. CODE OF 1954, §§ 2522(a)(2), 2055(a)(2).

8. Rev. Rul. 71-447, 1971-2 CUM. BULL. 230.

9. *See* Brief of Appellant at 10-13, Bob Jones Univ. v. Simon, ___ U.S. ___, 94 S.Ct. 2038 (1974) (Brief is published in 6 L. REPRINTS: TAX SERIES no. 1, 42-45 (1974).

10. INT. REV. CODE OF 1954, § 7421(a). Section (a) 7421 provides:

> (a) Tax.—Except as provided in Sections 6212(a) and (c), 6231(a) and 7426(a) and b(1), no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court by any person, whether or not such person is the person against whom such tax was assessed.

The three express exceptions to the INT. REV. CODE OF 1954, § 7421(a) do not apply to the cases in this note. The first exception provides that if the Commissioner has mailed to the taxpayer a notice of deficiency, and the taxpayer files a petition within the prescribed time, the Commissioner shall have no right to determine any additional deficiency of income tax for the same taxable year. If he does, then an injunction may issue. *Id.* § 6212(a), (c). Second, the Commissioner may not assess a deficiency until the taxpayer has been notified

to dismiss and granted an injunction *pendente lite* to the University.[11] On appeal, the Court of Appeals for the Fourth Circuit held that the court lacked jurisdiction, and dismissed the University's petition.[12]

A similar case, *Alexander v. "Americans United" Inc.*,[13] arose in Washington, D.C. "Americans United" is a nonprofit, educational corporation whose goal is to promote the principle of the separation of church and state through educating citizens. In 1950, a ruling letter[14] granted "Americans United" tax-exempt status.[15] In 1969 the Service revoked the 1950 ruling because "Americans United" was allegedly engaging in a substantial effort to influence legislation.[16] Unlike Bob Jones University, "Americans United" was permitted to continue its federal income tax-exemption as a social welfare institution under section 501 (c)(4).[17] However, contributions to "Americans United" were no longer tax-deductible. Subse-

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of such deficiency and the time in which the taxpayer may file a petition in the tax court has either expired or, if the petition has been filed, the decision of the tax court has become final. If the Commissioner makes such assessment, he may be enjoined. *Id.* § 6213(a). Third, the court may grant an injunction if a levy or sale would irreparably injure the property rights of third parties which the court determines to be superior to the rights of the United States. *Id.* § 7426 (a), b(1).

The predecessor of this provision was enacted in 1867 and was virtually the same as section 7421(a). Act of March 2, 1867, ch. 169, § 10, 14 Stat. 475. The legislative history of the Act of March 2, 1867, apparently remains a mystery. *See* Bob Jones Univ. v. Simon, ___ U.S. ___, 94 S.Ct. 2038, 2046 (1974); Gorowitz, *Federal Tax Injunctions and the Standard Nut Cases*, 10 TAXES 446 n.6 (1932); Note, *Enjoining the Assessment and Collection of Federal Taxes Despite Statutory Prohibition*, 49 HARV. L. REV. 109 n.9 (1935). The courts have held that the manifest purpose of § 7421(a) is to permit the United States to assess and collect taxes alleged to be due without judicial interference, and to require that the legal right to the disputed sums be determined by post-enforcement procedures such as a refund suit. Enoch v. Williams Packing & Nav. Co., 370 U.S. 1, 7 (1962). *See also* Bob Jones Univ. v. Simon, ___ U.S. ___, 94 S.Ct. 2038, 2046 (1974); Snyder v. Marks, 109 U.S. 189, 193-94 (1883); Cheatham v. United States, 92 U.S. 85, 88-89 (1875); State R.R. Tax Cases, 92 U.S. 575, 613-14 (1875); Dows v. City of Chicago, 78 U.S. (11 Wall.) 108, 110 (1871); Cohen v. Durning, 11 F.Supp. 824, 825-27 (S.D.N.Y. 1935).

11. Bob Jones Univ. v. Connally, 341 F. Supp. 277 (D.S.C. 1971), *rev'd*, ___ U.S. ___, 94 S.Ct. 2038 (1974).

12. Bob Jones Univ. v. Connally, 472 F.2d 903 (1973), *rehearing denied*, 476 F.2d 259 (4th Cir. 1973), *aff'd*, ___ U.S. ___, 94 S.Ct. 2038 (1974).

13. ___ U.S. ___, 94 S.Ct. 2053 (1974). "Americans United" is incorporated as "Protestants and other American United for Separation of Church and State."

14. Brief for Respondent at 1, 2, Alexander v. "Americans United" Inc., ___ U.S. ___, 94 S.Ct. 2053 (1974) (Brief is published in 6 L. REPRINTS: TAX SERIES no. 2, 1, 111-12 (1974)).

15. *See* statutes quoted notes 5 and 7 *supra*.

16. Alexander v. "Americans United" Inc., ___ U.S. ___, 94 S.Ct. 2053, 2056 (1974). *See* § 501(c)(3) and § 170 (c)(2)(d) quoted in notes 5 and 7 *supra*.

17. INT. REV. CODE OF 1954, § 501(c)(4). *See* Alexander v. "Americans United" Inc., ___ U.S. ___, 94 S.Ct. 2053, 2056 (1974).

quently, contributions decreased substantially.[18]

"Americans United" and two of its donors filed suit in the Federal District Court for the District of Columbia seeking injunctive relief requiring the reinstatement of its section 501(c)(3) tax-exempt status. "Americans United" alleged that the Commissioner's actions had caused irreparable harm in the form of the loss of contributions and had violated constitutional rights under the first and fifth amendments.[19] The District Court dismissed the action because of lack of subject matter jurisdiction,[20] basing the dismissal on section 7421(a) of the Internal Revenue Code of 1954.[21] The Court of Appeals for the District of Columbia Circuit affirmed the dismissal as to the donors, but it reversed as to "Americans United" and remanded.[22]

As a result of the conflict between the circuits with respect to the application of section 7421(a),[23] the United States Supreme Court granted certiorari in both cases.[24] In each case, the Court held that the petitioner's action to enjoin the revocation of tax-exempt status was prohibited by section 7421(a) of the Internal Revenue Code of 1954. The Court reasoned that the suits were brought "for the purpose of restraining the assessment or collection of [a] tax"[25]

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18. Brief for Respondent at 2, Alexander v. "Americans United" Inc., ___ U.S. ___, 94 S.Ct. 2053, 2056 (1974) (Brief is published in 6 L. REPRINTS: TAX SERIES no. 2, 1, 115-19 (1974)). Appearance on the *Cumulative List* of tax-deductible organizations was essential to "Americans United" in order to have a sufficient flow of contributions from donors, and the 1969 ruling removed it from the *Cumulative List*. *Id.* at ___, 94 S.Ct. at 2056, 2065 (dissenting opinion). *See also* Bob Jones University v. Simon, ___ U.S. ___, 94 S.Ct. 2038, 2042 (1974).

19. Brief for Respondent at 5-9, Alexander v. "Americans United" Inc., ___ U.S. ___, 94 S.Ct. 2053 (1974) (Brief is published in 6 L. REPRINTS: TAX SERIES no. 2, 1, 115-19 (1974)).

20. The District Court dismissed the complaint in an unpublished order filed March 9, 1971. *See* Alexander v. "Americans United" Inc., ___ U.S. ___, 94 S.Ct., 2053, 2057 (1974).

21. *See* note 10 *supra*.

22. "Americans United" Inc. v. Walters, 477 F.2d 1169 (D.C. Cir. 1973), *rev'd mem.*, 94 S.Ct. 2053 (1974).

23. For an extensive comparison of the two cases, see Bob Jones University v. Connally, 472 F.2d 903, (4th Cir. 1973), *rehearing denied*, 476 F.2d 259, 260 (4th Cir. 1973), *aff'd*, ___ U.S. ___, 94 S.Ct. 2038 (1974). In denying the motion for rehearing, the Court of Appeals distinguished the two cases. *But see* Note, *Applicability of Prohibition of Suits to Restrain Assessment and Collection of Taxes to Revocation of Tax Exemptions under Section 501(c)(3) of the Internal Revenue Code*, 73 COLUM. L. REV. 1502 (1973); Note, *Tax-Injunctions—The Federal Courts of Appeals Have Split over whether a Tax Exempt Organization May Enjoin IRS Revocation of Its Tax Exempt Status*, 62 GEO. L.J. 1019 (1974); Note, *"Americans United" Inc. v. Walters and Bob Jones University v. Connally: Revocation of Tax Exempt Status*, 46 TEMP. L.Q. 596 (1973); Note, *The Loss of Privileged Tax Status and Suits to Restrain Assessments*, 30 WASH. & LEE L. REV. 573 (1973).

24. *Cert. granted sub. nom.* Bob Jones Univ. v. Shultz, 414 U.S. 817 (1973); *Cert. granted* "Americans United" Inc. v. Walters, 412 U.S. 927 (1973).

25. *See* note 10 *supra*.

and, thus, were prohibited, despite allegations of constitutional violations, inadequacy of alternative remedies, and irreparable harm.

The language of section 7421(a), commonly referred to as the Anti-Injunction Act, would appear to preclude the granting of an injunction to prevent the assessment or collection of a tax. Nevertheless, section 7421(a) has been subject to several interpretations.[26] In early cases, courts interpreted the statute as an absolute prohibition against an injunction.[27] Then, in 1916, the Supreme Court denied an injunction but stated in dictum that "extraordinary and exceptional circumstances" might allow a court to enjoin the collection of a tax.[28] Subsequently, in *Hill v. Wallace*,[29] the Court applied the "extraordinary and exceptional circumstances" approach in granting an injunction to restrain the collection of a tax that allegedly would have financially ruined the grain futures market in the United States. However, a year later in *Graham v. Dupont*[30] the Court retreated from this view by classifying *Hill* with an earlier case, which held that the statute does not apply to a penalty in the form of a tax.[31] Then, in *Miller v. Standard Nut Margarine Co.*,[32] the Court readopted the "extraordinary and exceptional circumstances" doctrine. Standard Nut Margarine Company sought to restrain a tax on its products that would "destroy its

26. For a more detailed historical study see Lenoir, *Congressional Control over Suits to Restrain the Assessment or Collection of Federal Taxes*, 3 ARIZ. L. REV. 177 (1961); Note, *Applicability of Prohibition of Suits to Restrain Assessment and Collection of Taxes to Revocation of Tax Exemptions under Section 501(c)(3) of the Internal Revenue Code*, 73 COLUM. L. REV. 1502 (1973); Note, *Enjoining the Assessment and Collection of Federal Taxes Despite Statutory Prohibition*, 49 HARV. L. REV. 109 (1935); Note, *Procedural Due Process Limitations on the Suspension of Advance Assurance of Deductibility*, 47 S. CAL. L. REV. 427, 438 n.46 (1974); Note, *The Loss of Privileged Tax Status and Suits to Restrain Assessments*, 30 WASH. & LEE L. REV. 573 (1973); Annot., 65 A.L.R.2d 550 (1959); Annot., 108 A.L.R. 184 (1937).

27. *See* Pacific Steam Whaling Co. v. United States, 187 U.S. 447 (1903); Snyder v. Marks, 109 U.S. 189 (1883); Cheatham v. United States, 92 U.S. 85 (1876); State R.R. Tax Cases, 92 U.S. 575 (1876); *But see* Frayser v. Russell, 9 F. Cas. 728 (No. 5067) (C.C.E.D. Va. 1878); Pullan v. Kinsinger, 20 F. Cas. 44 (No. 11463) (C.C.S.D. Ohio 1870).

28. Dodge v. Osborn, 240 U.S. 118, 121-22 (1916).

29. 259 U.S. 44 (1922).

30. 262 U.S. 234, 258 (1923).

31. Lipke v. Lederer, 259 U.S. 557 (1922). The Court in *Lipke* held that the so-called tax of the National Prohibition Act was in reality a penalty designed to punish violations of the Act rather than a tax designed to raise revenue. Thus, the Anti-Injunction statute was inapplicable because the suit would not restrain the collection of a tax.

32. 248 U.S. 498 (1932). *Standard Nut Margarine Co.* is one of the main cases relied upon by Bob Jones University and "Americans United" in their briefs. *See* Brief for Appellant at 2, 10, 21, 22, 24, 25, 27, 39, Bob Jones Univ. v. Simon, ___ U.S. ___, 94 S.Ct. 2038 (1974); Brief for Respondent at 15, 19, 23 25, Alexander v. "Americans United" Inc., ___ U.S. ___, 94 S.Ct. 2053 (1974) (Briefs are published in 6 L. REPRINTS: TAX SERIES no. 1 and 2, 1 (1974)).

business, ruin it financially and inflict loss for which it would have no remedy at law."[33] The Supreme Court held that despite the Anti-Injunction Act, an injunction may be granted to prevent the collection of an illegal tax when there exist "special and extraordinary circumstances sufficient to bring the case within some acknowledged head of equity jurisprudence."[34] Thus, the Court viewed the Anti-Injunction Act as merely requiring the petitioner to show irreparable harm and the lack of an adequate remedy at law.[35]

In *Enoch v. Williams Packing & Navigation Co., Inc.*,[36] the Supreme Court significantly narrowed, without explicitly overruling, the *Standard Nut Margarine Co.* test. *Williams Packing* declared that an exception to the Anti-Injunction Act should be allowed only if: 1) equity jurisdiction exists and 2) it is clear that under no circumstances could the government ultimately prevail.[37] The two-fold *Williams Packing* test has been consistently followed to deny injunctions,[38] although a few cases have allowed the injunction upon an undeniable showing of illegality and bad faith.[39]

In both *Bob Jones University* and *"Americans United"* the Supreme Court declared that section 7421(a) is subject to no judicially-created exception other than the two-pronged *Williams Packing* test.[40] Although the Court acknowledged that both organi-

33. 284 U.S. at 510.

34. *Id.* at 509, 510.

35. This declaration of *Standard Nut Margarine Co.* was generally followed by the courts for several years. *See* Allen v. Regents of the Univ. System, 304 U.S. 439 (1938); Annot., 65 A.L.R.2d 550 (1959); Annot., 108 A.L.R. 184 (1937).

36. 370 U.S. 1 (1962). The Court denied an injunction to a corporation engaged in providing trawlers to fishermen. The corporation claimed that it was not the employer of the fishermen for purposes of social security and unemployment taxes and that collection of said taxes would destroy the plaintiff's business.

37. *Id.* at 7.

38. *See* Lucia v. United States, 474 F.2d 565 (5th Cir. 1973); Bowers v. United States, 423 F.2d 1207 (5th Cir. 1970); Transport Mfg. & Equip. Co. v. Trainor, 382 F.2d 793 (8th Cir. 1967); Kentucky v. Coyle, 352 F.2d 867 (7th Cir. 1965); Enterprises Unlimited Inc. v. Davis, 340 F.2d 472 (9th Cir. 1965); Johnson v. Wall, 329 F.2d 149 (4th Cir. 1964); Vuin v. Burton, 327 F.2d 967 (6th Cir. 1964); McCann v. United States, 248 F.Supp. 585 (E.D. Pa. 1965); Stone v. Phillips, 245 F. Supp. 247 (D. Colo. 1965); Galanti v. United States, 244 F.Supp. 528 (D.N.J. 1965); Cooper Agency, Inc. v. McLeod, 235 F.Supp. 276 (E.D.S.C. 1964), *aff'd*, 348 F.2d 919 (1965); Kornberg v. Tomlinson, 225 F.Supp. 70 (S.D. Fla. 1964), *aff'd*, 341 F.2d 300 (1965); Turner v. Burton, 213 F.Supp. 267 (N.D. Ohio 1962).

39. Anderson v. Richardson, 354 F.Supp. 363 (S.D.Fla. 1973) (government's tax claim was based on information gained by an illegal search and seizure); Center on Corporate Responsibility, Inc. v. Schultz, 368 F.Supp. 863 (D.D.C. 1973) (political influence played a role in the Internal Revenue Service's ruling). *See generally* Pizzarello v. United States, 408 F.2d 579 (2nd Cir. 1969), *cert. denied*, 396 U.S. 986 (1969); White v. Cardoza, 368 F.Supp. 1397 (E. D.Mich. 1973); McGlotten v. Connally, 338 F.Supp. 448 (D.D.C. 1972).

40. ___ U.S. at ___, 94 S.Ct. at 2048 (1974); ___ U.S. at ___, 94 S.Ct. at 2057 (1974).

zations had shown that equity jurisdiction existed,[41] the Court held that the charitable organizations' constitutional claims were "sufficiently debatable to foreclose any notion that under no circumstances could the Government ultimately prevail' . . . ."[42] Thus, *Bob Jones University* and *"Americans United'* had not fulfilled the second part of the *Williams Packing* exception and their suits were dismissed for lack of jurisdiction.

Although the *Williams Packing* test was expressly held to be controlling, the Court may have expanded the scope of the test beyond the limits of *Williams Packing*. The Court in *Williams Packing* strongly implied that if the "central purpose of the Act" is not in question, then section 7421(a) is inapplicable.[43] The "central purpose of the act" is to assure the United States "of the prompt collection of its lawful revenue."[44] Therefore, it could be argued that if there is no appreciable revenue to be collected, then the Act should not apply and the suit on the injunction should not be dismissed.

Both *Bob Jones University* and *"Americans United"* made this argument. In *Bob Jones University*, the petitioner argued that its primary purpose was not to obstruct the collection of revenue but instead was to enjoin the Service from withdrawing its section

41. Many donors will not contribute to a charitable organization that is not among those enumerated in the list of tax-deductible organizations. Thus, the revocation of an organization's tax-deductible status and consequent removal from the list is likely to result in a significant loss of donations. Bob Jones Univ. v. Simon, ___ U.S. ___, 94 S.Ct. 2038, 2042, 2051 (1974); Alexander v. "Americans United" Inc., ___ U.S. ___, 94 S.Ct. 2053, 2059 (1974). Furthermore, the remedies at law are inadequate to avoid or recover the loss of contributions for the interim between the revocation of the tax-deductible status and the final adjudication of the validity of the revocation. *See* Bob Jones Univ. v. Simon, ___ U.S. ___, 94 S.Ct. 2038, 2043, 2051 (1974); Alexander v. "Americans United" Inc., ___ U.S. ___, 94 S.Ct. 2053, 2059 (1974). *See* note 62 *infra*.

42. ___ U.S. at ___, 94 S.Ct. at 2052; ___ U.S. at ___, 94 S.Ct. at 2057-58.

43. 370 U.S. at 7. The court in *Williams Packing* states:

> Nevertheless, if it is clear that under no circumstances could the government ultimately prevail, *the central purpose of the act is inapplicable* and under the *Nut Margarine* case, the attempted collection may be enjoined if equity jurisdiction otherwise exists.

(emphasis added).

See McGlotten v. Connally, 338 F.Supp. 448 (D.D.C. 1972). In *McGlotten*, Chief Judge writing for the court concluded: "Even where the particular plaintiff objects to his own taxes, the court has recognized that the literal terms of the statute do not apply when 'the central purpose of the Act is inapplicable'." *Id.* at 454. *See* "Americans United" Inc. v. Walters, 477 F.2d 1169, 1178-79 (D.C. Cir. 1973), *rev'd mem.*, ___ U.S. ___, 94 S.Ct. 2053 (1974); Note, *Applicability of Prohibition of Suits to Restrain Assessment and Collection of Taxes to Revocation of Tax Exemptions under Section 501(c)(3) of the Internal Revenue Code*, 73 COLUM. L. REV. 1502, 1511-12 (1973).

44. 370 U.S. at 7.

501(c) (3) ruling letter and the advance assurances of deductibility in order to maintain the flow of contributions.[45] Petitioner contended that the tax liability of *Bob Jones University*, after the revocation of its tax status, would be insignificant. Thus, since there would be no significant taxes to restrain the Commissioner from collecting, an injunction *pendente lite* would not frustrate the central purpose of section 7421(a). The Court, however, concluded that since the petitioner had alleged in his complaint in District Court that he would suffer "substantial" income tax liability,[46] the allegations left "little doubt that a primary purpose of the lawsuit [was] to prevent the Service from assessing and collecting income tax."[47] Although the Court recognized that there is some doubt that *Bob Jones Univeristy* would actually be liable for federal income tax after the revocation of the tax exempt status,[48] the requested injunction would still restrain the collection of federal social security taxes (F.I.C.A.) and federal unemployment taxes (F.U.T.A.) from *Bob Jones University* and taxes from donors who would use the charitable contribution deduction to reduce their tax liability.[49]

The removal of section 501(c) (3) status normally subjects an organization to liability for income taxes, federal social security taxes (F.I.C.A.) and federal unemployment taxes (F.U.T.A.). However, in *"Americans United,"* "Americans United" still would have been exempt from the income tax despite the revocation because it qualified under section 501 (c) (4) as a social welfare institution.[50] In addition, *"Americans United"* had in the past voluntarily paid F.I.C.A. and F.U.T.A. taxes and stated its willingness to continue to do so even if it obtained an injunction.[51] Thus, *"Americans United"* had an even stronger argument than did *Bob Jones University* that the primary purpose of its suit could not be to restrain the assessment or collection of taxes. However, the Court concluded that the purpose of the suit was to restrain the collection of taxes from "Americans United's" contributors and thus reduce the level of taxes of its donors.[52] The Court did not analyze "Ameri-

45. ___ U.S. at ___, 94 S.Ct. at 2046.

46. The University had alleged federal income tax liability of three-quarters of a million dollars for one year and in excess of half a million dollars for another. ___ U.S. at ___, 94 S.Ct. at 2046-47.

47. *Id.* at ___, 94 S.Ct. at 2047.

48. *Id.* The University failed to take into account possible deductions for depreciation of plant and equipment.

49. *Id.*

50. INT. REV. CODE OF 1954, § 501(c)(4); ___ U.S. at ___, 94 S. Ct. at 2056.

51. ___ U.S. at ___, 94 S.Ct. at 2056, 2058.

52. ___ U. S. at ___, 94 S. Ct. at 2058.

can's United's" argument that most donors would probably redirect their contributions to other tax-deductible organizations. The result, if the organization's argument is valid, would be that the revenue collected will not be significantly affected by the loss of "Americans United's" section 501 (c) (3) and section 170 (c) (2) status.[53] The Court, by not analyzing this argument, seems to de-emphasize the role of the "central purpose of the Act" in its analysis of whether section 7421 (a) applies.

In *Bob Jones University*, the petitioner also argued that the Commissioner's true purpose was to coerce, through the use of the taxing power, private educational and religious institutions to adopt racially non-discriminatory admission policies and practices.[54] If the University were to compromise its religious beliefs and admit Blacks on a non-discriminatory basis, then the Unviersity could maintain its tax-exempt and tax-deductible status, and no additional taxes would be collected. From this, the petitioner concluded that the Commissioner's primary intent was not to collect taxes, but to implement policy-based guidelines. Because the prompt collection of revenue, the "central purpose of the Act," was not truly involved in the lawsuit, the University argued that the Anti-Injunction Act was inapplicable.[55]

The Court in *Bob Jones University*, however, found that "[t]here is no evidence that the position [of the Service] does not represent a good-faith effort to enforce the technical requirements of the tax laws. . . ."[56] This response did not answer the question of whether the Commissioner's primary intent was to collect taxes. Here again, there seems to be a de-emphasis of the "central purpose" test. By giving less weight to this approach, the Supreme Court has broadened the applicability of section 7421(a) beyond the scope of *Williams Packing*. The Court appears to say that even if the injunction would not significantly hinder the prompt collection of revenue, the injunction is still barred if the effect, no matter how indirect, is to restrain the collection of taxes.

In addition, the Court in *Bob Jones University* and *"Americans United"* employed the *Williams Packing* test in the face of constitu-

53. *See* statutes quoted note 5 and 7, respectively, *supra*.

54. ___ U.S. at ___, 94 S.Ct. at 2047. *See* Rev. Rul. 71-447, 1971-2 CUM. BULL. 230 (1970).

55. *Id. See* Note, *Applicability of Prohibition of Suits to Restrain Assessment and Collection of Taxes to Revocation of Tax Exemptions under Section 501(c)(3) of the Internal Revenue Code*, 73 COLUM. L. REV. 1502, 1510 (1973).

56. ___ U.S. at ___, 94 S.Ct. at 2047.

tional challenges which were absent in *Williams Packing*.[57] *Bob Jones University* and *"Americans United"* argued that *Williams Packing* should not be controlling when a substantial constitutional attack is made on the Service's ruling.[58] Nevertheless, the Supreme Court relied on *Williams Packing* in dismissing the first amendment, due process and equal protection claims of these organizations.[59] The Court in *"Americans United"* held that " . . . the constitutional nature of a taxpayer's claim . . . is of no consequence under the Anti-Injunction Act."[60]

By rejecting the "central purpose" approach and the organizations' constitutional arguments, the Supreme Court extended the prohibitory effects of section 7421(a) beyond the scope of *Williams Packing*—the primary precedent upon which the Court purportedly bases its decisions. The application of section 7421(a) to charitable organizations challenging the revocation of advance assurances of deductibility, makes it virtually impossible for such an organization to enjoin the revocation. The action is prohibited even though the institution may suffer extremely significant[61] and irreparable harm by the loss of contributions which may jeopardize its existence. The organization would have to show that under no circumstances could the government prevail before an injunction *pendente lite* could be granted. Obviously, the burden on one seeking to enjoin collection is practically insurmountable. Moreover, the alternative remedies of refund suit, donor suit and tax court suit are inadequate.[62]

57. 370 U.S. at 3, 4. The petitioner in *Williams Packing* contended that § 7421(a) should not bar his action because the fishermen to whom he rented trawlers were not his employees for purposes of determing liability for social security and unemployment taxes.

58. The rationale for this argument is that when a classification penalizes or restrains the exercise of a constitutional right, the courts tend to hold that greater procedural safeguards should be provided. *See, e.g.*, Speiser v. Randall, 357 U.S. 513 (1958); Note, *Taxation—Anti-Injunction Act: A Suit Brought by Non-Taxpayers Challenging the Constitutionality of a Revenue Statute Is Not Barred by the Anti-Injunction Act Where Such Suit Only Incidentally Affects the Tax Liability of Third Parties*, 40 BROOKLYN L. REV. 489, 506-07 (1973).

59. ___ U.S. at ___, 94 S.Ct. at 2052.

60. ___ U. S. at ___, 94 S.Ct. at 2058.

61. The Supreme Court in *Bob Jones University* concluded that the degree of harm is irrelevant in determining if § 7421(a) prohibits the suit. ___ U.S. at ___, 94 S.Ct. at 2050.

62. A charitable organization ordinarily has five possible remedies: 1) administrative review by the Service; *see* 9 J. MERTENS, LAW OF FEDERAL INCOME TAXATION §§ 49.110, 49.112, 49.114, 49.115, & 49.118-124 & (Rev. Ed. 1971); 5 RABKIN & JOHNSON, FEDERAL INCOME, GIFT AND ESTATE TAXATION § 71.02C (1974); 2) a refund suit after the payment of a tax; INT. REV. CODE OF 1954, § 7422; 28 U.S.C. §§ 1346 (a)(1), 1491 (1970); 3) a suit in the tax court after the receipt of a deficiency notice; INT. REV. CODE OF 1954, §§ 6612, 6213; 4) a suit by a "friendly" donor whose claim based on the contribution was not allowed; and 5) a suit to enjoin *pendente lite* the revocation of the charitable organization's status. *See generally* Thrower, *IRS Is Considering Far Reaching Changes in Ruling on Exempt Organizations*, 34

Furthermore, the degree of bureaucratic control that has been given the Service over charitable organizations is susceptible to abuse, regardless how conscientiously the Service attempts to carry out its duties.[63] The Service is permitted to damage irreparably charitable institutions upon the merest chance that the Commissioner might be right.[64] This virtual plenipotentiary power is particularly hazardous in the light of recent findings that political pressure may unduly influence the Service's determination of the tax status of philanthropic organizations.[65] In addition, a former Commissioner of the Service contends that the danger of such a power is that it gives a greater finality to Service rulings than was intended by Congress.[66]

Since the Supreme Court has taken such a firm stand[67] on its interpretation of section 7421(a) in two recent cases, it is unlikely that it will reverse itself in the near future. Therefore, correction of this harshness and susceptibility of abuse should merit congres-

J. OF TAX. 168 (1971). Administrative review is often an inadequate remedy because the final revocation decision is made by the Service which has broad discretion in such matters. The Service is subject to independent review only by the filing of a refund suit, tax court suit, donor suit or suit for unjunctive relief. Except for the injunction *pendente lite* relief the judicial remedies present serious problems of delay during which the charitable organization is certain to lose contributions. *See* Bob Jones Univ. v. Simon ___ U.S. ___, 94 S.Ct. 2038, 2042-43, 2051 (1974); Alexander v. "Americans United" Inc., ___ U.S. ___, 94 S.Ct. 2053, 2059 (1974). Under the very best of circumstances it would be at least one year after the revocation before a court would decide the issue. Furthermore, this assumes that the charitable organization wins and the government does not appeal. If an appeal is made, several years may pass before a final decision is made. *See* Alexander v. "Americans United" Inc., ___ U.S. ___, 94 S.Ct. 2053, 2067 (dissent).

In addition to the problem of delay, a suit for a refund or in the tax court may be unfeasible because even after the revocation of the tax-exempt and tax-deductible status, most charitable organizations have no tax liability and thus have no payment of taxes issue to litigate. *See* Brief for Respondents at 23 and n.22, Bob Jones Univ. v. Simon, ___ U.S. ___, 94.SCt. 2038 (1974) (the Commissioner's brief); Note, *supra* note 58, at 497-98. Also, a "friendly" donor suit is questionable as an adequate remedy for the charitable organization because of the difficulty of finding a willing donor to both contribute and file suit and because the organization must depend on the contributor to assert the rights of the organization. Bob Jones Univ. v. Simon, ___ U.S. ___, 94 S.Ct. 2038, 2051 n.21 (1974).

63. Bob Jones Univ. v. Simon, ___ U.S. ___, 94 S.Ct. 2038, 2052 (1974).

64. *See* the dissent of Senior Circuit Judge Boreman in Bob Jones Univ. v. Connally, 472 F.2d 903, 908 (4th Cir. 1973), *aff'd*, ___ U.S. ___, 94 S.Ct. 2038 (1974).

65. Center on Corporate Responsibility, Inc. v. Schultz, 368 F. Supp. 863 (D.D.C. 1973). *See also* Note, *Tax-Injunctions— The Federal Courts of Appeals Have Split Over Whether a Tax Exempt Organization May Enjoin IRS Revocation of Its Tax Exempt Status*, 62 GEO. L.J. 1019, 1031-32 (1974).

66. Thrower, *IRS Is Considering Far Reaching Changes in Ruling on Exempt Organizations*, 34 J. OF TAX. 168 (1971).

67. In *Bob Jones University* and in "Americans United", Justice Powell delivered the opinions of the Court for seven justices; Justice Douglas took no part in the decisions and Justice Blackman concurred and dissented, respectively.

sional consideration.[68] Congress has amended section 7421(a) in the past[69] to circumscribe the discretion of the Internal Revenue Service and similar steps should be taken in the future.[70]

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68. The Supreme Court on both *Bob Jones University*, ___ U.S. ___, 94.S.Ct. 2038, 2052, and *"Americans United"*, ___ U.S. ___, 94 S.Ct. 2052, 2059 n.14, suggests that Congress should consider specific treatment of charitable organizations to allow them to seek injunctive relief.

69. Each of the three express exceptions to § 7421(a) were added by amendment. *See* note 10 *supra*.

70. Section 7421 (a) should be amended to allow injunctive relief when a revocation of § 501(c)(3) and § 170(c)(2) status is challenged. This recommendation should not be construed to mean that there are no other areas that might also merit consideration as exceptions to § 7421(a).

ULTIMATE LIABILITY FOR THE FEDERAL ESTATE TAX IN MISSOURI: CHARITABLE LEGATEES EXONERATED

In re Estate of Wahlin[1]

Carl Wahlin, a bachelor, died testate. His will was admitted to probate by the Probate Court of Jackson County, Missouri. The will contained clauses directing payment of debts and expenses, a sole specific bequest of personal property, and a bequest of the remainder of his estate as follows: twenty-five percent to each of two individual legatees, twenty-five percent to a charitable institution, and the remaining twenty-five percent to six named charitable institutions. The will did not expressly direct which shares were to bear the burden of the federal estate tax.

Testator's gross estate for federal estate tax purposes[2] amounted to $281,227.39.[3] After subtraction of debts, expenses, and the sole specific bequest, the residuary estate amounted to $133,113.89. The total federal estate tax due was $29,445.11.[4] The

1. 505 S.W.2d 99 (Mo. App., D.K.C. 1973).

2. The gross estate includes all property (except real property situated outside the United States) to the extent of the interest therein of the decedent at the time of his death; dower and curtesy and their statutory substitutes; transfers in contemplation of death; transfers taking effect at death, including transfers with a reservation of a life interest and revocable transfers; annuities; survivorship in joint estates; powers of appointment; and life insurance. INT. REV. CODE of 1954, §§ 2031-44. For an amplified discussion of specific problems in computing the gross estate, see R. STEPHENS & G. MAXFIELD, THE FEDERAL ESTATE AND GIFT TAXES 36-161 (2d ed. 1967); Lowndes, *An Introduction to the Federal Estates and Gift Taxes*, 44 N. C. L. REV. 1, 3-30 (1965); C. LOWNDES AND R. KRAMER, FEDERAL ESTATE AND GIFT TAXES 6, 24-294 (2d ed. 1962).

3. Nearly half of this amount was non-probate property, consisting of property owned jointly by testator and the individual legatees and insurance, of which one individual legatee was the beneficiary.

4. The federal estate tax was computed as follows:

Probate property	$155,663.86
Non-probate property (*see* note 3 *supra*)	125,563.53
Gross estate	281,227.39
Less: expenses of administration and debts of testator	21,905.97
Adjusted gross estate	259,321.42
Less: exemption	60,000.00
Less: deduction for charitable contributions	66,556.96
Net taxable estate	132,764.46
Federal Estate Tax	30,529.34
Less: credit for state inheritance taxes	1,084.23
Federal Estate Tax due	$ 29,445.11

executrix filed a petition to construe the will to determine where the ultimate burden of the federal estate tax should fall. The central issue was whether the charitable legatees should be exonerated from contributing to the payment of the tax.[5] Both the Probate Court and the Circuit Court of Jackson County held that the charitable legatees were exonerated from contributing to the payment of the tax. The individual legatees appealed. The Missouri Court of Appeals affirmed, holding that, absent a contrary testamentary intention expressed in the will, the doctrine of equitable apportionment applied, and charitable legatees were exonerated from contributing to the payment of the federal estate tax.[6]

The Internal Revenue Code of 1954 requires that the federal estate tax be paid by the executor.[7] This provision merely dictates that the executor has the duty to pay the tax in the first instance. It does not constitute a federal mandate determining the ultimate liability for payment of the tax.[8] The allocation of the ultimate burden of the federal estate tax is a question of state law.[9]

Unlike many other states,[10] Missouri has no statute expressly directing the manner of allocating the ultimate burden of the federal estate tax. In addition, Missouri courts have not found any implied legislative direction in other state statutes dealing with decedent's

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The deduction for charitable bequests was computed as if the charitable beneficiaries were not liable for any estate tax. *See* note 15 *infra*, for a discussion of the problem of calculating the amount of this deduction if the residuary charitable legatees must bear part of the estate tax burden.

5. The court also reaffirmed the principle that, absent a contrary provision in the will, takers of non-probate property are liable for contribution to payment of the federal estate tax, to the extent that the non-probate property generated the tax. 505 S.W.2d at 112. *Accord*: Love v. St. Louis Union Trust Co., 497 S.W.2d 154 (Mo. En Banc 1973); Commerce Trust Co. v. Starling, 393 S.W.2d 489 (Mo. 1965); Sebree v. Rosen, 349 S.W.2d 865 (Mo. 1961); Carpenter v. Carpenter, 364 Mo. 782, 267 S.W.2d 632 (1954).

6. 505 S.W.2d at 112.

7. Section 2203 of the Internal Revenue Code defines "executor" as being the executor or administrator of a decedent's estate, or, if there is no executor or administrator, any person in actual or constructive possession of any property of the decedent.

8. Riggs v. Del Drago, 317 U.S. 95 (1942).

9. *Id.* at 98; Pitts v. Hamrick, 228 F.2d 486 (4th Cir. 1955). *Accord*: United States v. Traders Nat. Bank, 248 F.2d 667, 670 (8th Cir. 1957); Saracino v. St. Louis Union Trust Co., 254 S.W.2d 600, 603 (Mo. 1952); *In re* Poe's Estate, 356 Mo. 276, 282, 201 S.W.2d 441, 444 (1947); Priedman v. Jamison, 356 Mo. 627, 632, 202 S.W.2d 900, 903 (1947); *In re* Bernheimer's Estate, 352 Mo. 91, 109, 176 S.W.2d 15, 22 (1943).

10. For a discussion of the varied state statutes dealing with the burden of the federal estate tax see Powell, *Ultimate Liability for Federal Estate Taxes*, 1958 WASH. U.L.Q. 327; Annot., 37 A.L.R.2d 199 (1954). Two versions of a uniform law have also been proposed. UNIFORM ESTATE TAX APPORTIONMENT ACT (1958); UNIFORM ESTATE TAX APPORTIONMENT ACT (1964).

estates.[11] Hence, the process of determining the ultimate burden of the federal estate tax in Missouri has been one of judicial interpretation.

Regardless of the presence or absence of a state statute regarding allocation of the federal estate tax, a testator may place the ultimate burden of the federal estate tax wherever he wishes by a provision in his will.[12] In *Wahlin*, the court found no such provision.[13]

11. In Hammond v. Wheeler, 347 S.W.2d 884, 889 (Mo. 1961) the Missouri Supreme Court said that the federal estate tax was not a "debt" within the meaning of § 469.090, RSMo 1949 (repealed, Mo. Laws 1955, at 385, § A), the widow's election statute in effect at the time. In Jones v. Jones, 376 S.W.2d 210, 217-18 (Mo. En Banc 1964) the supreme court said that §§ 474.160 and 474.190(2), RSMo 1955 Supp., concerning the surviving spouse's elective share, merely prescribed the form of the election, but did not constitute legislative preclusion of the application of the doctrine of equitable apportionment. In Reed v. United States, 316 F. Supp. 1228, 1232-33 (E.D. Mo. 1970)(applying Missouri law), the court said that § 473.620, RSMo 1969, relating to the abatement of legacies, does not modify or otherwise affect the doctrine of equitable apportionment. Finally, in In re Estate of Wahlin, 505 S.W.2d 99 (Mo. App., D.K.C. 1973) the court of appeals found that the following state statutes did not preclude the application of the doctrine of equitable apportionment: §§ 473.620, .623, RSMo 1969, (regarding abatement of legacies), *id.* at 107 (citing Reed v. United States, *supra*); §§ 472.010 and 473.397(3), RSMo 1969, (dealing with the duty of an executor or administrator to pay all debts, including taxes), *id.* at 106-07; § 474.430, RSMo 1969, (regarding the effect given to a testator's intent), *id.* at 107.

12. *See e.g.*, Reed v. United States, 316 F. Supp. 1228, 1230 (E.D. Mo. 1970) (applying Missouri law); St. Louis Union Trust Co. v. Krueger, 377 S.W.2d 303, 304 (Mo. En Banc 1964); Carpenter v. Carpenter, 364 Mo. 782, 795, 267 S.W.2d 632, 640 (1954). *See generally* Annot. 37 A.L.R.2d 7 (1954).

13. In *Wahlin* the individual legatees had urged the court to hold that the will expressed testamentary intent precluding the application of the doctrine of equitable apportionment, relying on the reasoning of St. Louis Union Trust Co. v. Krueger, 377 S.W.2d 303 (Mo. En Banc 1964). In *Krueger*, testatrix left one-half of her gross estate to her husband, with the provision that, "[s]hould my husband predecease me, I hereby give and bequeath my said husband's share to my nephew . . . ." The husband survived the testatrix, and the issue confronting the court was whether the husband's bequest should bear a share of the federal estate tax. The supreme court said that, since testatrix did not specifically state in her will what source was to be used to pay the federal estate tax, it was reasonable to assume that she intended it to be paid from her gross estate, and that the bequest to her husband be effective only as to that part of the gross estate over which testatrix had the power to direct disposition—*i.e.*, the net or distributive estate. Furthermore, the court found in the words "my said husband's share" a testamentary intention that the nephew, as contingent beneficiary, should receive the identical share in case of the husband's death that the husband would receive if he survived. Since any bequest to the nephew would be burdened with a share of the federal estate tax, the court concluded that testatrix intended the bequest to her husband to bear a like share of the tax.

In *Wahlin* the court rejected the *Krueger* approach, citing two differences in the Krueger and Wahlin wills which it deemed sufficient to prevent the inference of a testamentary direction of the allocation of the ultimate burden of the federal estate tax in the Wahlin will. First, the Wahlin will provided for fractional share of the residuary estate, not for fractional shares of the gross estate as in the Krueger will. Second, the Wahlin will included a provision that if one individual legatee predeceased testator, "that portion of my estate which she

Absent a controlling state statute or a testamentary direction as to where the burden of the federal estate tax is to fall, the courts have taken two different approaches to allocate the ultimate burden of the tax.[14] The first, the so-called "burden on the residue" doctrine, requires the amount of the federal estate tax to be paid out of the residuary estate before the distributive shares are calculated.[15] The second, the so-called "equitable apportionment" doc-

would have received under this will" was to go to one of the charitable legatees. This provision involved a deduction in determining testator's net taxable estate only if the contingent beneficiary took, not if the primary beneficiary took, as in the Krueger will. 505 S.W.2d at 111.

Although these differences provide a technical ground for distinguishing *Krueger*, they are far from overwhelming. In fact, the court could easily have reached the opposite conclusion on this crucial point. The fact that the court chose to distinguish *Krueger* suggests that, although *Krueger* was affirmed in principle, the court looked upon it as being at the outer limit of cases in which testamentary intention as to the ultimate burden of the federal estate tax would be inferred.

Cf. Reed v. United States, 316 F. Supp. 1228, 1232 (E.D. Mo. 1970) (applying Missouri law); Jones v. Jones, 376 S.W.2d 210, 212 (Mo. En Banc 1964) for language suggesting that testamentary provisions allocating the ultimate burden of the federal estate tax must be clearly expressed.

14. 42 AM. JUR.2d *Inheritance, Estate, and Gift Taxes* § 344 (1969); Annot., 37 A.L.R.2d 169 (1954).

15. Jurisdictions following the "burden on the residue" doctrine are presented with a difficult valuation problem. Section 2055(c) of the Internal Revenue Code of 1954 says that, if gifts qualifying for the charitable deduction are to bear a share of the federal estate tax or other state taxes, the amount of the charitable deduction is to be the amount bequeathed less any amount paid in taxes. In effect, this makes the amount of the deduction dependent on the amount of the tax, and the amount of the tax dependent on the amount of the deduction. In Edwards v. Slocum, 264 U.S. 61 (1924), *aff'g.* 287 F. 651 (2d Cir. 1923), Justice Holmes criticized these "mutually dependent indeterminates" as departing from the normal practice of not regarding the incidence of a tax in the levying of a tax and as being contrary to the express intention of the statute to encourage charitable giving. Nevertheless, Congress has seen fit to enact such a provision, and its validity was upheld in Harrison v. Northern Trust Co., 317 U.S. 476 (1943). Thus, in states that require residuary charitable legatees to bear a share of the tax, the total tax payable is increased because the charitable deduction is decreased by the share of the tax it will be required to pay. This is a circular, cumulative process, in which the amount of the charitable deduction is reduced by subtracting therefrom the share of the tax it will be required to pay, which in turn reduces the amount passing to charity, which in turn increases the size of the taxable estate and the estate tax liability, which further reduces the amount passing to charity, etc. A similar cumulative process was held valid, in another setting, in Estate of Aldrich v. Commissioner, 425 F.2d 1395, 1399-1400 (5th Cir. 1970) (involving the valuation of a lifetime usufructory interest in a bequest to charity). The problem is exacerbated when there are mutually dependent state and federal taxes. These problems are usually solved through the use of algebraic formulae. *See* 1 FED. EST. & GIFT TAX REP. ¶ 2023.99, ¶ 2090.07; 4 MERTENS, LAW OF FEDERAL GIFT AND ESTATE TAXATION 641-716 (1959). Jurisdictions follow ing the equitable apportionment doctrine do not, of course, face this problem. For a discussion of the merits and shortcomings of each approach *see* Lauritzen, *Apportionment of the Federal Estate Taxes*, 1 TAX COUN. Q. 55 (1957); 1958 WASH. U. L. Q. 89, 91-93 (1954); Sutter, *Apportionment of the Federal Estate Tax in the Absence of Statute of an Expression of Intention*, 51 MICH. L. REV. 53, 54 (1952).

trine, requires each bequest or other item of property included in testator's gross estate which generates part of the federal estate tax to bear a proportionate share of the tax.

An early case established the "burden on the residue" doctrine as the rule in Missouri.[16] However, in *Carpenter v. Carpenter*,[17] the Missouri Supreme Court rejected that doctrine and adopted the "equitable apportionment" rule. This case involved an annuity contract which was included in testator's gross estate for estate tax purposes, but which did not pass under the will. Confronted with the issue of whether the burden of the tax attributable to the annuity contract should be borne by the beneficiary of the contract or by the residuary legatees, the court said that the controversy should be decided "upon equitable principles,"[18] and held that the beneficiary should pay the amount of the federal estate tax generated by the annuity contract. Since the decision in *Carpenter*, the doctrine of equitable apportionment has been applied consistently in Missouri.[19]

The Internal Revenue Code permits, in addition to the $60,000 exemption to which all estates are entitled, two important deductions from the adjusted gross estate[20] in determining the net taxable estate. The first, the "marital deduction," permits a deduction of the value of any interest in property passing to a surviving spouse, not to exceed fifty percent of the adjusted gross estate.[21] The second, the "charitable deduction," permits a deduction of the value of all bequests "to or for the use of any corporation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes . . . ."[22] Since property qualifying for either the marital or the charitable deduction is not included in the net taxable estate, it generates no federal estate tax.

In Missouri, the doctrine of equitable apportionment has been applied in cases involving the marital deduction, with the result

16. *In re* Holmes' Estate, 328 Mo. 143, 40 S.W.2d 616 (1931).

17. 364 Mo. 782, 267 S.W.2d 632 (1954).

18. *Id.* at 796, 267 S.W.2d 632, 642.

19. *See e.g.*, Reed v. United States, 316 F. Supp. 1228 (E.D. Mo. 1970) (applying Missouri law); Love v. St. Louis Union Trust Co., 497 S.W.2d 154 (Mo. En Banc 1973); *In re* Estate of Hough, 457 S.W.2d 687 (Mo. 1970); Commerce Trust Co. v. Starling, 393 S.W.2d 489 (Mo. 1965); Jones v. Jones, 376 S.W.2d 210 (Mo. En Banc 1964).

20. The starting point for calculating the federal estate tax is the "gross estate," discussed in note 2, *supra*. The adjusted gross estate is computed by subtracting funeral expenses, administration expenses, and debts of the decedent from the gross estate. INT. REV. CODE OF 1954, § 2053.

21. INT. REV. CODE OF 1954, § 2056.

22. INT. REV. CODE OF 1954, § 2055(a)(2).

that property passing to a spouse which qualifies for the deduction has been exonerated from contributing to the payment of the federal estate tax.[23] *In re Estate of Wahlin* raised, for the first time in Missouri, the issue of whether property qualifying for the charitable deduction should also be exonerated. The court applied the doctrine of equitable apportionment and held that the charitable legatees were exonerated from contribution to the payment of the tax. Relying on the cases involving the marital deduction,[24] the court reasoned that since property qualifying for the charitable deduction generates no tax liability, the charitable legatees should be exonerated from contributing to the payment of the tax.

The importance of the decision in *Wahlin* is twofold. First, its holding that, absent a contrary testamentary provision, charitable legatees are not liable to contribute to payment of the federal estate tax, makes for more certainty in this area of estate planning. This holding is especially important since testamentary charitable giving is likely to become increasingly significant in estate planning.[25] Second, the decision reinforces the notion that, absent a contrary testamentary provision, "Missouri is committed to the doctrine of equitable apportionment . . . ."[26]

However, the real lesson of *Wahlin* is that tax consequences should be fully considered by estate planners, and provision made for allocation of the tax burden in the will. If this is done, judicial interpretation and allocation of the burden is unnecessary, "because the will settles it."[27] Prudent estate planners would be well-advised to avoid ambiguous language, in order to avoid costly and time-consuming litigation. The best interests of the testator and the ob-

23. In Hammond v. Wheeler, 347 S.W.2d 884 (Mo. 1961), testator's wife renounced the will and elected to take her statutory share. The supreme court held that, since her statutory share did not contribute to the generation of the federal estate tax, her share should be exonerated from contributing to its payment. Three years later, a similar issue was presented in Jones v. Jones, 376 S.W.2d 210 (Mo. En Banc 1964). The facts of this case were essentially the same as in *Hammond*, but the issue was raised as to whether the Missouri Probate Code of 1955 (enacted after the controversy in *Hammond* arose) constituted legislative direction precluding the application of the doctrine of equitable apportionment. The supreme court said that the Probate Code did not deal with the ultimate burden of the federal estate tax, and applied the doctrine of equitable apportionment, thus exonerating the widow from contributing to the payment of the tax.

24. See note 23 *supra*.

25. *Cf.* Snyder, *The Role of Charitable Contributions in Estate Planning: How to Eat Part of Your Cake and Keep Almost All of It*, 9 WAKE FOREST L. REV. 343 (1973).

26. Reed v. United States, 316 F. Supp. 1228, 1232 (E.D. Mo. 1970) (applying Missouri law).

27. St. Louis Union Trust Co. v. Krueger, 377 S.W.2d 303, 306 (Mo. En Banc 1964).

jects of his bounty dictate that tax allocation provisions be clear and precise.[28]

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28. Some suggested tax provisions are found in Lauritzen, *Apportionment of Federal Estate Taxes*, 1 TAX COUN. Q. 55, 91 (1957); 3 J. RABKIN AND M. JOHNSON, CURRENT LEGAL FORMS WITH TAX ANALYSIS 8-1285 (1974); AM. JUR. LEGAL FORMS 2d, *Inheritance, Estate, and Gift Taxes* ch. 145, §§ 145.31-145.36 (wills), §§ 145.40-145.44 (trusts). For will provisions which have been judicially construed, see Annot., 37 A.L.R.2d 7 (1954). The latter collection should serve as a list of phrases to avoid in order to prevent the possibility of litigation due to ambiguity.

TAX CONSEQUENCES OF REPAYMENTS BY INSIDERS IN SATISFACTION OF SECTION 16 (b) OF THE SECURITIES EXCHANGE ACT OF 1934

Anderson v. Commissioner[1]

I. INTRODUCTION

On four occasions[2] in the last four years, the Tax Court has considered the question of what kind of tax deduction is to be allowed for payments made pursuant to section 16(b) of the Securities Exchange Act of 1934.[3] The court has been consistent in allowing the taxpayer an ordinary deduction under section 162(a) of the Internal Revenue Code of 1954.[4] The first two cases have been reversed by the Sixth Circuit[5] and the Seventh Circuit,[6] respectively. This note will consider the *Anderson* case, the reversal by the Seventh Circuit, and its impact on future decisions.

II. THE *Anderson* CASE

Taxpayer, James E. Anderson, purchased 1000 shares of Zenith Radio Corporation common stock for $14,039 during 1962 and 1963 while he was vice president of Zenith. He sold these shares on April 1 and 7, 1966 realizing a capital gain of $148,884. On April 11, 1966, Anderson purchased another 750 shares of Zenith common stock for $49,312. The Zenith legal department advised Anderson that his insider[7] sales of April 1 and 7 and purchase of April 11 fell within

1. 480 F.2d 1304 (7th Cir. 1973), *rev'g*, 56 T.C 1370 (1971).

2. Charles I. Brown, P-H 1973 TAX CT. MEM. ¶ 73,275 (Dec. 17, 1973); Nathan Cummings, 60 T.C. 91 (1973), *aff'd. on rehearing*, 61 T.C. No. 1 (Oct. 2, 1973); James E. Anderson, 56 T.C. 1370 (1971), *rev'd*, 480 F.2d 1304 (7th Cir. 1973); William L. Mitchell, 52 T.C. 170 (1969), *rev'd*, 428 F.2d 259 (6th Cir. 1970), *cert. denied*, 401 U.S. 909 (1971), *non acquiescense in*, 1970-2 CUM. BULL. xxii.

3. 15 U.S.C. § 78(p)(b)(1970). Section 16(b) provides in part:

> "For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months . . . ."

4. INT. REV. CODE OF 1954, § 162(a) which allows a deduction for all ordinary and necessary expenses incurred in a trade or business.

5. Commissioner v. Mitchell, 428 F.2d 259 (6th Cir. 1970), *cert. denied*, 401 U.S. 909 (1971), *rev'g*, 52 T.C. 170 (1969), *non acquiescense in*, 1970-2 CUM. BULL. xxii.

6. Commissioner v. Anderson, 480 F.2d 1304 (7th Cir. 1973), *rev'g*, 56 T.C. 1370 (1971).

7. 15 U.S.C. § 78(p)(a)(1970). Section 16(a) defines insiders as:

the prohibitions of section 16(b) and that Zenith was entitled to the profit. In 1966 he paid the profit of $51,259[8] to Zenith as demanded.

On his 1966 return, taxpayer treated the $148,884 gain on the sale of the stock as long term capital gain[9] and the $51,259 payment to Zenith as an ordinary and necessary business expense. The Commissioner determined that the payment should be treated as long-term capital loss[10] rather than an ordinary and necessary business expense. The Tax Court held for the taxpayer in deciding that the payments were deductible under section 162(a)[11] and did not require capital loss treatment, since they were made to preserve taxpayer's employment and to avoid injury to his business reputation.

The issue on appeal was whether *Arrowsmith v. Commissioner*[12] applied, so that the section 16(b) payment assumed the character of the earlier sale, which was a long-term capital transaction. The Seventh Circuit followed the Sixth Circuit's reversal of the *Mitchell*[13] case and concluded that *Arrowsmith* was applicable. The

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"Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered pursuant to section § 781 of this title, or who is a director or an officer of the issuer of such security . . . ."

8. *See generally* 2 L. Loss, Securities Regulation 1062-66 (2d ed. 1961). For treatment of multiple transactions *see* Nelson, *Tax Deductibility of Insider Profit Repayments: Resolving An Apparent Conflict*, 24 Case W. Res. L.Rev. 330, 351-52 (1973). For treatment of options see Kornfeld v. Eaton, 327 F.2d 263, 265 (2nd Cir. 1964), discussing 17 C.F.R. § 240.16(b)-6(a) and (b) (Supp. 1973).

9' The Internal Revenue Code sections applicable to long-term capital gain are: Int. Rev. Code of 1954, § 1222(3) which defines long-term capital gain as that "gain from the sale or exchange of a capital asset held for more than 6 months."; Int. Rev. Code of 1954, § 1202 which allows a deduction from gross income of fifty percent of the amount by which the net long-term capital gain exceeds the net short-term capital loss.

10. The sections applicable to long-term capital loss are: Internal Revenue Code of 1954, § 1222(4), which defines long-term capital loss as that "loss from the sale or exchange of a capital asset held for more than six months."; and Internal Revenue Code of 1954, § 1211(b)(1) which provides in part:

(1) In general — . . . losses from sales or exchanges of capital assets shall be allowed only to the extent of the gains from such sales or exchanges, plus (if such losses exceed such gains) whichever is the smallest:

(A) taxable income
(B) $1,000, or
(C) the sum of —
(i) The excess of the net short-term capital loss over the net long-term capital gain, and
(ii) one-half of the excess of the net long-term capital loss over the net short-term capital gain.

11. Int. Rev. Code of 1954 § 162(a).

12. 344 U.S. 6 (1952). *See* text accompanying note 27 *infra.*

13. Commissioner v. Mitchell, 428 F.2d 259 (6th Cir. 1970), *cert. denied*, 401 U.S. 909 (1971), *rev'g*, 52 T.C. 170 (1969), *non acquiescence in*, 1970-2 Cum. Bull. xxii. *See* text accompanying note 30 *infra.*

business purpose of the payment was held to be irrelevant, since the nature of the deduction was controlled by the nature of the income item from which it was derived' Thus the taxpayer was limited to a long term capital loss deduction'

III. Historical Considerations of the Conflict

The early cases held that a payment in satisfaction of section 16(b) was in the nature of a penalty and was neither deductible as an ordinary and necessary business expense nor as a capital loss. The case of *William F. Davis, Jr.*,[14] first established this penalty doctrine. There, petitioner was vice president and director of United Drug, Inc. He incurred section 16(b) liability by purchasing 2000 shares of his corporation's stock within six months after he had sold 1000 shares. Petitioner reported $20,469 long term capital gain on his 1945 return.

The Securities and Exchange Commission upon examination of petitioner's transactions notified United Drug of the section 16(b) liability. Thereupon, petitioner was requested to pay $12,659 to the company; the difference between the proceeds realized from the sale and the price subsequently paid for a like number of shares. Petitioner paid the amount requested in 1946 and sought to deduct the payment on his 1946 return either as a business expense under section 23(a)(1)[15] or as a loss under section 23(e)[16] of the Internal Revenue Code *of* 1939.

Respondent contended that payment pursuant to section 16(b) was a penalty and that to allow a deduction would frustrate the policy of the section. Petitioner, relying on the legislative history[17] of section 16(b), claimed that the obligation was not penal and that a deduction would not frustrate the intent of the act. The court held that the payment was a penalty and any deduction for such payment would be against public policy and contrary to the intent of the act.[18]

14. William F. Davis, Jr., 17 T.C. 549 (1951).

15. This section was the forerunner of section 162(a) of the Internal Revenue Code of 1954.

16. This section was the forerunner of section 165(c) of the Internal Revenue Code of 1954.

17. Petitioner relied on the Report of the Securities and Exchange Commission on Proposal for Amendments to the Securities Act of 1933 and the Securities Exchange Act of 1934, August 7, 1941, p. 36: "The consequences of failing to comply with this standard (section 16(b)) are not penal. The section does not make insiders' trading unlawful; it does not even subject insiders to injunctive proceedings." *See* 2 L. Loss, Securities Regulation 1037, 1085 (2d ed. 1961); Nelson, *Tax Deductibility of Insider Profit Repayments: Resolving An Apparent Conflict*, 24 Case W. Res. L.Rev. 330, 342 nn. 44-46 (1973).

18. The holding is questioned in 2 L. Loss, Securities Regulation 1037, 1085 (2d ed.

This case was followed in I.T. 4069[19] and was the precedent for subsequent case law,[20] until the *Laurence M. Marks*[21] case in 1956. In this case taxpayer voluntarily paid to his company the profits of $17,672[22] which represented the amount agreed to be his maximum liability under section 16(b). The payment was made "to avoid unfavorable publicity and injury to his business reputation, and to avoid extended controversy and the expense of litigation." The sole issue raised was the deductibility of the payment as a business expense. The Tax Court held for the taxpayer and allowed the deduction as an ordinary expense to protect his business reputation, and concluded that the allowance of the deduction in the circumstances in question would not violate the policy expressed in section 16(b). After the *Marks* case and Revenue Ruling 61-115[23] which was issued following *Marks*, the penalty notion was never argued again as a reason for denial of a deduction. However, the question of ordinary deduction versus capital loss was not at issue in *Marks*.

In considering this issue, it must be remembered that the primary purpose of section 16(b) is to place the insider in the position he would have occupied had he not engaged in the stock transactions.[24] The goal of the Securities and Exchange Act of 1934 was an open securities market without unfair advantages for insiders. Since corporation insiders have access to information not available to most traders, 16(b) was adopted to remove the profit from short-swing trading by insiders in their corporation's stock. It was said in *Smolowe v. Delendo Corporation*[25] that "(T)he statute was intended

1961) where it is stated: "Actually six judges of the Tax Court dissented in the *Davis* case, and the balance might have been the other way save for the peculiar juxtaposition of § 16(b) and the Internal Revenue Code under the facts of the case."

19. 1952-1 CUM. BULL. 28 *(revoked.)*

20. *See* Robert Lehman, 25 T.C. 629 (1955); William L. Dempsey, 10 P-H TAX CT. MEM. 936 (1951).

21. 27 T.C. 464 (1956), *acquiesced in*, 1966-2 CUM. BULL. 6.

22' The taxpayer was the senior partner of an investment banking company and was a shareholder and director of Shamrock Oil and Gas Corporation. In the years 1948 and 1949 the partnership dealt in Shamrock stock several times and realized a gross profit of $45,313 from these transactions. Taxpayer received as his share of the Shamrock transactions $17,672 which was included in his partnership profits as *ordinary* income. Shamrock was alerted by the Securities and Exchange Commission to the possible 16(b) violation. No determination was ever made that the taxpayer violated section 16(b) and the taxpayer never admitted to a violation.

23. 1961-1 CUM. BULL. 46.

24. *See* Bershad v. McDonough, 428 F.2d 693, 696 (7th Cir. 1971), *cert. denied*, 400 U.S. 992 (1970); *See e.g.*, Booth v. Varian Associates, 334 F.2d 1, 3(1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965); Adler v. Klawans, 267 F.2d 840 (2d Cir. 1959).

25. Smolowe v. Delendo Corp., 136 F.2d 231 (2d Cir. 1943), *cert. denied*, 320 U.S. 751 (1943).

to be thoroughgoing, to squeeze all possible profits out of stock transactions . . . ."[26] To be consistent with the intent of section 16(b) a deduction must return the taxpayer as nearly as possible to his original position.

The net tax result is an important factor to consider in determining what kind of deduction is most consistent with the purpose of 16(b). An ordinary and necessary business expense will be offset against ordinary income in full while a capital loss deduction can offset against ordinary income in full while a capital loss deduction can offset a maximum of $1000 in ordinary income. Thus the ordinary business deduction may result in a benefit to the taxpayer which is inconsistent with section 16(b). The courts have not used the net tax result in a comparison with the intent of section 16(b), but it is perhaps the most important argument.

The courts have used two cases outside the area of section 16(b) to characterize the deduction for the 16(b) payment as a capital loss. In *Arrowsmith v. Commissioner*,[27] a final distribution was made to two share holders on the liquidation of their corporation in 1940. These taxpayers reported these payments as capital gains. In 1944 a judgment was rendered against the corporation; each shareholder paid half and deducted his payment in full as an ordinary and necessary business expense. The Commissioner looked to the 1940 treatment of the distribution as a capital gain and determined that the 1944 payment was a capital loss. The Supreme Court held the payments to be capital losses since the taxpayer's liability was based on the sale of a capital asset and not an ordinary business transaction. All the events of the distribution and repayment were examined not to reopen and readjust the 1940 return, but to determine the nature of the 1944 payment.[28] The court concluded that where the taxpayer receives and reports a capital gain, a subsequent payment made by that taxpayer in satisfaction of a liability arising from the earlier capital transaction must be treated as a capital loss. In *United States v. Skelly Oil Co.*,[29] taxpayer paid tax on certain

26. *Id.* at 239. *See, e.g.*, Feder v. Martin Marietta Corp., 406 F.2d 260 (2d Cir. 1969), *cert. denied*, 396 U.S. 1036 (1970).

27. 344 U.S. 6 (1952).

28. This result does no violence to the annual accounting system, since the earlier returns are not being reopened. The earlier year is being examined to determine whether the repayment gives rise to a regular or a capital loss. *See e.g.*, Eugene H. Walet, Jr., 31 T.C. 461 (1958); Note, *Tax Treatment of Payments For Apparent Violations of Section 16(b) of the Securities Exchange Act of 1934*, 36 ALBANY L. REV. 736 (1972); 2 L. LOSS, SECURITIES REGULATION, 1036, 1086 (2d ed. 1961). The *Arrowsmith* doctrine merely extends the claim of right doctrine developed in Burnet v. Sanford & Brooks Co., 282 U.S. 359 (1931) and North American Oil Consolidated v. Burnet, 286 U.S. 417 (1932).

29. 394 U.S. 678 (1969).

income from sales of natural gas after deducting the 27 ½% depletion allowance. In a subsequent tax year the taxpayer was required by a regulatory board to refund portions of this income to its customers because of overcharges. The taxpayer attempted to deduct the full amount of the refunded income while the Internal Revenue Service contended that the deduction should be reduced by 27 ½% to correspond with the prior depletion deduction allowed against the income when received. The court held that it was proper to consider the earlier transaction in order to determine the tax consequence of the later expenditure and that the deduction should be reduced by 27 ½%. These two cases are said to stand for the general proposition that when income which was taxed at a reduced rate is later given up, the taxpayer should not be permitted to deduct the refund in full as an ordinary deduction.

The Tax Court first considered the nature of the section 16(b) payment in *William L. Mitchell*[30] and concluded that the payment resulted in an ordinary and necessary business expense. There the taxpayer, vice president of General Motors Corporation, sold and repurchased 2130 shares of General Motors stock within a six month period. He reported the profit on the sale as long-term capital gain on his 1962 return and took an ordinary deduction under 162(a) for the repayment on his 1963 return. The Commissioner disallowed the deduction relying on Revenue Ruling 61-115 and *Arrowsmith v. Commissioner*, to require characterization of the payment as a capital loss due to the integral relationship of the payment and the earlier sale. *Arrowsmith* required that where there is such a relationship an income tax deduction must be characterized by the income item from which it is derived and without which it would not have been paid. The Tax Court found *Arrowsmith* inapplicable since it did not find the requisite relationship between the gain and the 16(b) payment, and allowed the taxpayer an ordinary deduction because the payment was made to avoid injury to his business reputation. The Sixth Circuit reversed, finding *Arrowsmith* and *Skelly* applicable and the business purpose of the payment irrelevant. The taxpayer was limited to a capital loss deduction in 1963 because of his capital gain treatment of the 1962 sale profits.

In 1971 the Tax Court again considered the deductibility of section 16(b) payments in *James E. Anderson*.[31] Here the court emphasized the business purpose of preserving the taxpayer's employ-

30. 52 T.C. 170 (1969), *rev'd*, 428 F.2d 259 (6th Cir. 1970), *cert. denied*, 401 U.S. 909 (1971), *non acquiescence in*, 1970-2 CUM. BULL. xxii.

31. 56 T.C. 1370 (1971).

ment and business reputation[32] and stated: "Thus *Arrowsmith* and *Skelly Oil* are both distinguishable because the payment was not directly and integrally related to the earlier sale transaction which gave rise to the capital gain and because the status of petitioner in making the payment differed from that which he had at the time such gain was realized."[33] The court followed its earlier decision and allowed taxpayer an ordinary and necessary business expense under 162(a).

While *Anderson* was on appeal to the Seventh Circuit, the Tax Court on April 23, 1973 decided *Nathan Cummings*.[34] On facts similar[35] to *Anderson* the Tax Court allowed Cummings an ordinary and necessary business expense deduction under section 162(a) relying on the reasoning of *Mitchell* and *Anderson* for the nonapplicability of *Arrowsmith*. On June 14, 1974 *Anderson* was reversed by the Seventh Circuit on the grounds that *Arrowsmith* did apply and that the right of deduction under 162(a) for protection of business reputation was irrelevant.

Based on the reversal of *Anderson*, the Commissioner moved for reconsideration and revision of the *Cummings* opinion by the Tax Court. The Tax Court reviewed the opinion but its earlier findings were not affected by the Seventh Circuit reversal and it entered the decision for Cummings on October 2, 1973 stating: "We have carefully re-examined our position in the light of the views expressed by the Seventh Circuit, but with due respect to that court, we are not

32. *See, e.g.*, Joseph P. Pike, 44 T.C. 787 (1965); Old Town Corp., 37 T.C. 845 (1962); Laurence M. Marks, 27 T.C. 464 (1956), *acquiesced in*, 1966-2 CUM. BULL. 6; Paul Draper, 26 T.C. 201 (1956); William L. Butler, 17 T.C. 675 (1951). *See* Nelson, *Tax Deductibility of Insider Profit Repayments: Resolving An Apparent Conflict*, 24 CASE W. RES. L.REV. 330 (1973); Note, A CORPORATE INSIDER NOT ALLOWED TO DEDUCT PAYMENTS MADE TO AVOID THREATENED 16(B) LITIGATION AS AN ORDINARY BUSINESS EXPENSE BUT ONLY AS A CAPITAL LOSS, U. TOL. L. REV. 559 (1971).

33. 56 T.C. at 1375 (1971).

34. 60 T.C. 91 (1973).

35. In *Cummings* taxpayer was a director and shareholder of MGM. In the year 1961 taxpayer sold and then bought 3000 shares of MGM within a six month period. The Securities Exchange Commission notified MGM who in turn notified the taxpayer in 1962 of the possible 16(b) violation. The profit, $53,870.81, was paid to the corporation in 1962 and a deduction was taken as an ordinary and necessary business expense. The respondent determined that the payment should be a long-term capital loss since the gain on the sale of the stock was long-term capital gain. The court found, as petitioner contended, that the payment was made to protect the business reputation of the taxpayer and to avoid any delay in the issuance of MGM's proxy statement which was dated the day after the payment was made. The court held for petitioner and allowed the payment to be deducted as an ordinary and necessary business expense and the opinion was filed on April 23, 1973. The court relied on *Mitchell* which was reversed by the sixth circuit and *James E. Anderson* which was then on appeal to the Seventh Circuit.

convinced that our position should be changed. Since venue for appeal of this case is in the Second Circuit, we are not required to follow the decisions of the Circuit Courts in *Anderson v. Commissioner*, and *Mitchell v. Commissioner*."[36] The outcome of the *Cummings* case is still pending. An appeal was granted December 28, 1973 and the decision should have significant impact on future Tax Court opinions in this area.

The most recent case decided by the Tax Court is *Charles I. Brown*,[37] filed December 17, 1973. Taxpayer purchased and sold shares of Western Nuclear Inc. within a six month period while he was vice president.[38] He reported $49,060 long term capital gain on his 1966 return. Taxpayer paid the section 16(b) profit to the company to avoid damaging his business reputation and took a business expense deduction for the payment in 1968. The Commissioner asked for reconsideration of the rule applied in prior cases, but the Tax Court declined to adopt a different standard for determining the character of the deduction from that it had used in *Mitchell*, *Anderson* and *Cummings*.[39] Thus the Tax Court persists in resolving this issue for the taxpayer.

IV. Does Arrowsmith Apply?

The basic question raised throughout the cases is whether *Arrowsmith* applies. A narrow reading of the case merely allows a prior year to be examined to determine the character of a repayment in a subsequent year when the two transactions are related. Both the Courts of Appeal and the Tax Court have applied the case to section 16(b) repayments but each has reached different interpretations: (1) The Tax Court has interpreted *Arrowsmith* to require a

36. Nathan Cummings, 61 T.C. No. 1, CCH Dec. 32, 158 at 3056 (Oct. 2, 1973).

37. 42 P-H Tax Ct. Mem. 1251 (Dec. 17, 1973).

38. In *Brown*, taxpayer was vice president and treasurer of Western Nuclear Inc. He purchased 16,000 shares of Western for $57,569 in 1966. Between January and May of 1966 taxpayer sold 3000 shares of Western stock acquired in 1959 and 1960 for $58,325, thus realizing long term capital gain of $49,060. He also incurred section 16(b) laibility of $37,795 which was subsequently paid to Western. It is interesting to note that at the Tax Court level there was a six man dissent on the review decision of the *Cummings* case, two of whom dissented in *Anderson*. In *Brown*, two months later, on nearly identical facts and without a court change there was no dissent. This could represent a backing off by the Tax Court and a willingness to allow the ordinary deduction without serious dispute. In addition, the court in *Brown* did not even discuss *Arrowsmith*.

39. The court in *Brown* sets up a two part rule for deductibility as an ordinary and necessary business expense: (1) the taxpayer was in the trade or business of being a corporate executive and (2) payments were made to protect his employment and business reputation' this, the court says, has been followed in all the prior cases though it has never been explicitly stated.

relationship between two transactions which is sufficient to require the conclusion that both transactions are "parts of a unified whole."[40] Although this relationship has never been met to the satisfaction of the Tax Court in the 16(b) cases, it is agreed that if it is met, the tax treatment of a prior year will control the treatment in a subsequent year. (2) The Sixth and Seventh Circuits have emphasized the rationale that was stated in *Skelly* that "[I]f money was taxed at a special lower rate when received, the taxpayer would be accorded an unfair tax windfall if repayments were generally deductible from receipts taxable at the higher rate applicable to ordinary income."[41] The circuits have recognized that there must be a relationship between the two transactions, but have given a broader interpretation to this requirement and have found the relationship to exist when the origin of the deduction is the earlier capital transaction,[42] in effect an origin test.

The Tax Court has held *Arrowsmith* inapplicable for lack of an integral relationship, on several different theories. In *Mitchell* the Tax Court stated that the relationship being considered was between the *purchase*, which had no tax consequences, and the *repayment*; since the sale was a completed transaction.[43] The court also stated that there was no relationship between the amount of gain and the amount of payment under section 16(b).[44] In *Anderson* the Tax Court found a lack of integral relationship because of a "status" argument, *i.e.*, the taxpayer had different capacities at sale and at repayment. During the sale upon which long term capital gain was realized he acted in his capacity as a shareholder, but his obligation to make payment arose out of his status as an employee.[45]

40. James E. Anderson, 56 T.C. 1370, 1376 (1971).

41. 394 U.S. 678, 685 (1969). This rationale can be said to be based on public policy and on policy of section 16(b). This brought a reaction from Judge Campbell in his dissent in *Anderson*, 480 F.2d at 1309 (1973). In this dissent the questions are posed as to whether the Internal Revenue Code should enforce the policies of the Securities Exchange Act of 1934 and whether equity has a place in the tax law administration.

42. Referring to the *sale* of stock, whether it is the sale or a subsequent purchase that triggers 16(b) liability.

43. The sale is said to be a completed transaction and the purchase is said to have only securities law significance. Payment of the 16(b) liability is then based on the purchase and thus there is no tax relationship between the two transactions. This rationale applies only in sale-purchase cases since in the puchase-sale situation it is the sale which triggers 16(b) liability.

44. An example used to demonstrate this position is: a basis of $20 per share, a sale of that share for $10, and a subsequent repurchase within 6 months of the same stock at $5 per share. In this example there would be a loss on the sale transaction, yet a $5 per share profit recoverable in violation of section 16(b). *See* William L. Mitchell, 52 T.C. at 174-75 (1969); 2 L. Loss, Securities Regulation 1037, 1062 (2d ed. 1961).

45. This argument has been seriously questioned, since the net effect of this status

In *Cummings* the Tax Court grounded its opinion on: (1) the lack of correlation between the amount of capital gain and the amount of repayment, as was argued in *Mitchell*; and (2) the "status" argument of *Anderson*. On review the court added that "had the payment been made in the same year as the gain was recognized, it would not have reduced the amount of such capital gain."[46]

The Sixth Circuit, in *Mitchell*, responded to the integral relationship theories by saying that the payment is controlled by the underlying sale-purchase transaction which gave rise to the section 16(b) liability. Both the sale and purchase were said to be needed and thus 16(b) relates to the whole transaction, not merely the sale or the purchase individually.[47] The Seventh Circuit found sufficient relationship in the fact that the taxpayer acted in the capacity of an insider at all times during the transactions[48] and held that the payment and sale-purchase transaction as a whole were "inextricably intertwined".[49]

Whether *Arrowsmith* applies seems to be a matter of semantics. The Tax Court in allowing an ordinary deduction has failed to find the high degree of relationship that it feels is needed for *Arrowsmith* to apply. The circuits define the necessary relationship in such a way that *Arrowsmith* does apply. Neither interpretation is a sound basis for future cases. A better approach would be to test the results obtained by each possible alternative against the purpose and intent of 16(b).[50]

V. Characterization of Deduction Based on the Intent of 16(b)

The Sixth and Seventh Circuits have both bolstered their interpretation of *Arrowsmith* by stressing that they prevent the taxpayer

theory is to allow an officer an ordinary and necessary business expense, since he made the repayment as an employee; but to limit a director or 10% shareholder to capital losses since the repayment would be in the capacity as a shareholder. The theory is that if the capacity at sale and at repayment is the same, that of a shareholder, then there would be an integral relationship satisfying *Arrowsmith* and a capital loss would be appropriate. This treats the classes of insiders differently. *See e.g.*, 56 T.C. 1370 (1971) (Dawson & Quealy, JJ., dissenting); Note, *Repayment of Profits Realized in Violation of Section 16(b) of the Securities Exchange Act of 1934 By A Corporate Officer In Order to Protect His Corporate Position and Business Reputation Is Deductible By Him As An Ordinary and Necessary Business Expense*, 9 Houston L.Rev. 841 (1972).

46. 61 T.C. No. 1, CCH Dec. 32, 158 at p.3057 (Oct. 2, 1973).

47. 428 F.2d at 261.

48. This application of the status theory treats all insiders the same and avoids the problems that a contrary holding would cause. *See* Nelson, *Tax Deductibility of Insider Profit Repayments: Resolving An Apparent Conflict*, 24 Case W. Res. L. Rev. 330, 338 (1973).

49. Anderson v. Commissioner, 480 F.2d 1304 at 1307 (7th Cir. 1973) quoting from the dissenting opinion in the Tax Court, 56 T.C. 1370 (1971).

50. *See* text accompanying note 25-26 *supra*.

from getting the windfall result of a double deduction from his payment. This is in effect an argument based on the intent of section 16(b) and not an integral relationship rationale. By a comparison of the net tax benefit from the deduction, with the intent expressed by section 16(b), a more logical treatment of the deduction can be determined. There are at least four possible treatments that have been suggested: (1) allowance of an ordinary and necessary business expense deduction in the year of repayment;[51] (2) application of section 1341 of the Internal Revenue Code *of* 1954[52] to the repayment;[53] (3) allowance of a capital loss deduction in the year of repayment;[54] (4) an addition of the amount repaid to the basis of the stock purchased.[55]

Revenue Ruling 61-115 declares the purpose of 16(b) to be "to place the insider in the same position he would have occupied if he had never engaged in the stock dealings."[56] A more understandable expression of this concept is to describe the purpose to be to return the insider to the position he would have occupied had he bought and sold at the same price.[57]

The allowance of a deduction against ordinary income as an ordinary and necessary business expense in the year of repayment

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51. The Tax Court has followed this in *Mitchell, Anderson, Cummings* and *Brown.*

52. INTERNAL REVENUE CODE OF 1954, § 1341 provides in part:

If:

(1) an item was included in gross income for a prior taxable year because it appeared that the taxpayer had an unrestricted right to such item,

(2) a deduction is allowed when it is established that taxpayer did not have an unrestricted right to such item; and

(3) the amount exceeds $3000 then the tax imposed is the lesser of,

(4) the tax for the current taxable year computed with such deduction, or

(5) amount equal to —

(A) The tax for the current year computed without such deduction, minus

(B) The decrease in tax for the prior year resulting from exclusion of such item from gross income.

53. *See e.g.*, Nelson, *Tax Deductibility of Insider Profit Repayments: Resolving An Apparent Conflict*, 24 CASE W. RES. L. REV. 330, 349-51 (1973); Lokken, *Tax Significance of Payments In Satisfaction of Liabilities Arising Under Section 16(b) of the Securities Exchange Act of 1934*, 4 GA. L. REV. 298, 312-21 (1970).

54. The Sixth and Seventh Circuits have opted for this approach.

55. William L. Mitchell, 52 T.C. 170 (1969) (Drennen and Tietzens, J.J., concurring); Nathan Cummings, 61 T.C. No. 1 (Oct. 2, 1973) (Drennen J., dissenting); Lokken, *Tax Significance of Payments in Satisfaction of Liabilities Arising Under Section 16(b) of The Securities Exchange Act of 1934*, 4 GA. L. REV. 298, 309-12 (1970). If the stock is resold prior to the year that the 16(b) payment is paid or if it is a purchase followed by a sale the deduction would be characterized by the nature of the gain or loss on the sale of the *purchased* stock. *Id'* at n.66'

56. 1961-1 CUM. BULL. 46 at 48.

57. Lokken, *Tax Significance of Payments In Satisfaction of Liabilities Arising Under Section 16(b) of the Securities Exchange Act of 1934*, 4 GA. L. REV. 298, 309 (1970).

clearly frustrates the intent of section 16(b) when the sale that fixes liability under the section is capital in nature. Such a characterization results in an after tax profit to the taxpayer from his insider trading.[58] When the sale transaction produces a long term capital gain it appears that an ordinary deduction should not be allowed if the net tax result is to be in compliance with Revenue Ruling 61-115 and the intent of section 16(b).

Since the claim of right doctrine and the annual accounting period rule prevent reopening of the prior year's return, section 1341 was devised to give the taxpayer an alternative when an item is taken into income and must be repaid in a subsequent year. However, application of section 1341 to the repayment of section 16(b) liability has several obstacles,[59] which, when viewed as a whole, raise serious doubts as to its applicability under present interpretation.[60]

The allowance of a capital loss deduction and the addition to basis of the amount of 16(b) liability repaid can both be justified with respect to the intent of section 16(b). In each instance the general principles of *Arrowsmith* are applied, since the court must refer back to a prior year to determine the type of treatment to be afforded in the current year; but the fact that *Arrowsmith* does apply is not determinative and the absence of any rigid relationship tests can avoid the semantic problems that have surrounded the problem. When the court refers back to the circumstances involved

58. The taxpayer realizes a long term capital gain from the sale which is reduced by fifty percent before it is added to ordinary income. If the taxpayer is allowed an ordinary deduction for the repayment, he can deduct this in full against ordinary income. Thus he will have only put half the gain into ordinary income and taken a deduction in full for the repayment.

59. The main obstacle is Revenue Ruling 68-153, 1968-1 CUM. BULL. 371, which requires that a taxpayer have had an unrestricted right to the funds when received. Section 1341 requires an "appearance" of an unrestricted right. Thus far mistake of fact has not been sufficient for such "appearance" and presumably this strict interpretation would preclude mistake of law as well. Also Section 1341 must be tied to a sale so it would not be applicable to a sale-purchase factual pattern. The section would not apply if the original sale produced a loss or if the amount of payment exceeded the gain. Lokken, *Tax Significance of Payments in Satisfaction of Liabilities Arising Under Section 16(b) of the Securities Exchange Act of 1934*, 4 GA. L. REV. 298, 317 (1970).

60. *See* Nelson, *Tax Deductibility of Insider Profit Repayments: Resolving An Apparent Conflict*, 24 CASE W. RES. L.REV. 330, 349-351 (1973), where the author proposes reconsideration of Revenue Ruling 68-153 and applicability of section 1341 to insider repayments. For illustration: Taxpayer holds stock with a basis of $20. He sells the stock at $25, generating $5 of capital gain. He purchases more stock at $15 incurring section 16(b) liability of $10. Treating this $10 payment as a capital loss has the same effect on the taxpayer as if he had sold at $15—he has a net capital loss of $5. If taxpayer purchases at $20 and later sells for $25 incurring 16(b) liability of $5, treating this payment as a $5 capital loss would have the same effect as if taxpayer had sold for $20—*no* capital gain or loss.

in the transactions that triggered 16(b) liability, the intent of the section will dictate whether a capital loss or an addition to basis should be allowed. This may raise arguments from the taxpayer that he is being penalized by a capital loss in a subsequent year when he has no capital gains. But this result is inherent in the annual accounting rule and the fact that the tax law does not afford exactly parallel treatment to capital gains and losses. This inequity would result from any method other than an adjustment of the taxpayer's tax liability for prior years.

The goal of returning the taxpayer to the economic position he would have held had he bought and sold at the same price requires tax treatment sufficiently flexible to be properly applied whether the 16(b) transaction is a sale followed by a purchase or a purchase followed by a sale. 16(b) liability is always premised on a short-term profit result from two closely related transactions. In the sale-purchase sequence the advantage comes when the stock price swings down during the intervening few days; in the purchase-sale sequence the insider profits when the price swings up. In one situation, the 16(b) liability is actually premised on the purchase and sale of the same shares of stock, but more commonly it is premised on the purchase of certain shares within a short time before or after the sale of other shares which may have been held by the insider for a long period of time and in which he may have either a high or low basis. The 16(b) liability is based on the fiction that the short swing sale is at a profit. However, the tax consequences of the actual sale will be determined by which stock is actually sold; how long that stock was owned; and whether it is sold at a gain or a loss. Thus, the tax consequences of the sale will not necessarily correspond with the short term profit result which gives rise to the 16(b) liability.

The section 16(b) sanction is imposed in the sale-purchase sequence on the theory that the taxpayer really didn't sell anything since he bought back within such a short period of time. Thus, for 16(b) purposes, the substance of the transaction was to average down the insider's cost of stock, freeing up invested capital without making any substantial change in his ownership of stock. To correct this resulting advantage, section 16(b) requires the insider to pay to the corporation the amount of capital which the transaction thereby freed up, *i.e.* the amount by which the sale price exceeded the subsequent purchase. The tax treatment of this payment which would best correspond to this rationale for the 16(b) payment would be to treat the payment as an investment in the cost of the stock; thus bringing the cost of the stock to an amount equal to the prior sale price. This tax treatment would be accomplished by merely adding

the amount of the 16(b) payment to the taxpayer's basis in the stock provided he still owns the stock when the 16(b) payment is made. If the stock has been disposed of in the intervening period, the taxpayer should be afforded a capital loss deduction, either short term or long term depending on the character of the sale of the purchased stock. This deduction is the nearest equivalent possible to increased basis where the stock is no longer held by the taxpayer.

The other sequence involves a purchase followed within a short period by a sale. Although the short-term result must be a profit before 16(b) liability will result, the actual sale may be of either the stock purchased a short time before or of some other stock of the same kind purchased at an earlier time. In this latter event, the tax consequences of the sale may be either short term or long term and at either a gain or a loss. However, the 16(b) liability is predicated on the theory, actual or fictional, that the recently purchased stock was sold at a profit. The advantage to the insider is taken from him by requiring that he pay the resulting short term profit to the corporation. Thus the sale price is constructively reduced to an amount equal to the prior purchase. The tax consequences which best correspond to this approach of 16(b) would be to allow the taxpayer a deduction keyed to the tax consequences of the sale, *i.e.* a capital loss which is either short term or long term depending on the character of stock actually sold.

VI. Conclusion

In a sale-purchase sequence the addition to basis method, combined with a capital loss treatment where there is no stock to adjust, is justifiable in light of the intent of section 16(b). In a purchase-sale sequence, a capital loss characterized by the nature of the stock sold will likewise comply with the intent of the section. Both methods will yield tax penalties in some situations, but they both avoid any possible tax windfall to the insider which would weaken the sanctions of section 16(b). The *Anderson* court's choice of a capital loss method was an acceptable result but will be questioned so long as it relies on the relationship analysis. A decision based squarely on furthering the public policy of section 16(b) would be a desirable development in this area of the law.

Richard J. Stahlhuth

TORTS—MINOR CHILD'S CONTRIBUTORY NEGLIGENCE DOES NOT BAR PARENTAL CLAIM FOR TORTIOUS INJURY TO CHILD BY THIRD PARTY

Handeland v. Brown[1]

Vincent Handeland, a minor, was injured when the motorcycle he was operating collided with an automobile driven by Jane Eileen Brown and owned by Dennis Brown. Vincent's father, Ronald Handeland, as next friend, brought a negligence action against the Browns for his personal injuries. Ronald also joined the action to assert his own claim under Rule 8[2] which provides, "A parent, or the parents, may sue for the expense and actual loss of services, companionship and society resulting from injury to or death of a minor child."[3] The defendants pleaded Vincent's alleged contributory negligence as a bar to both claims. At trial, the court refused to instruct that any negligence of Vincent would not bar the plaintiff's claim under Rule 8. The jury was instructed that if they found Vincent negligent and his negligence was a proximate cause of his injuries, the defendants should prevail on the claims of both Vincent and his father.[4]

The jury found for the defendants on both claims. Ronald appealed his claim based on Rule 8. The single issue on appeal was whether the trial court erred in instructing the jury that a defense of contributory negligence which would be good against Vincent would also be good against Ronald. The Supreme Court of Iowa held that a child's contributory negligence, not the sole proximate cause of his injuries, is not a defense to a parental claim under Rule 8.[5]

Prior to *Handeland*, American decisions unanimously recognized that contributory negligence by a spouse or child is a defense to the other spouse's or a parent's recovery of the collateral damages arising from the personal injury.[6] American courts have advanced various rationales to justify this result. In *Chicago, Burlington & Quincy Railroad v. Honey*,[7] the court applied an imputed negligence

1. 216 N.W.2d 574 (Iowa 1974).
2. IOWA R. CIV. P. 8 [hereinafter referred to as Rule 8].
3. *Id.*
4. Handeland v. Brown, 216 N.W.2d 574, 575 (Iowa 1974).
5. *Id.* at 574.
6. 41 AM. JUR.2D *Husband and Wife* § 401 (1968); 59 Am. Jur.2d *Parent and Child* § 126 (1971); 41 C.J.S. *Husband and Wife* § 452 (1944); 67 C.J.S. *Parent and Child* § 47 (1950). The injured party's assumption of the risk or a statute of limitations applicable to him have also been held to defeat the recovery. W. PROSSER, LAW OF TORTS § 125. (4th ed. 1971).
7. 63 F. 39 (8th Cir. 1894).

theory in holding that a wife's contributory negligence barred her husband's claim for consortium and medical expenses arising from the wife's injury by a negligent third party.[8] The court followed the now discarded principle that a husband is to be held responsible for the conduct of his wife. The wife's contributory negligence was imputed to the husband as a complete bar to recovery of the collateral damages he suffered as a result of his wife's injuries.[9]

The court in *Callies v. Reliance Laundry Co.*,[10] held that a parent's negligence action to recover medical expenses and loss of services due to the physical injury of his child was barred by the child's contributory negligence. The court specifically rejected the imputed negligence theory and introduced the assignment rationale as a basis for denying recovery. Stating that the parent is required by law to support his child, the court reasoned that the parent in return takes a part of the child's cause of action by operation of the law and must necessarily take the claim as the child leaves it.[11]

The derivative action theory was discussed in *Dudley v. Phillips*.[12] The court acknowledged the existence of both the imputed negligence and assignment theories, but reasoned that a cause of action arising in favor of a parent as a result of a tort against the child is by nature derivative and therefore is subject to the same defenses that are available with respect to the claim arising in favor of the child.[13] Missouri appears to follow the derivate action rationale. In *Huff v. Trowbridge*,[14] the Missouri Supreme Court held that a wife could not recover on her collateral claim for her husband's injuries if he was contributorily negligent, because her claim was merely derivative.[15]

A fourth approach which has been employed to deny recovery is the "well-settled rule" theory of *Ross v. Cuthbert*.[16] In *Ross*, the Oregon court acknowledged that the general rule had been subject to valid criticism, but felt compelled to deny recovery because the

8. *Id.* at 42.

9. *Id.* at 41. Since the husband's right to recover was dependent upon the marriage relationship and could not exist without it, the court was able "with no logical difficulty" to hold the husband accountable for the wife's contributory negligence. *Id.* at 42.

10. 188 Wis. 376, 206 N.W. 198 (1925).

11. *Id.* at 380-81, 206 N.W. at 200.

12. 218 Tenn. 648, 405 S.W.2d 468 (1966); *see* Annot., 21 A.L.R. 3d 469 (1968). The opinion in *Dudley* placed heavy reliance on 39 AM. JUR. *Parent and Child* § 85 (1942).

13. Dudley v. Phillips, 218 Tenn. 648, 656, 405 S.W.2d 468, 469 (1966).

14. 439 S.W.2d 493 (Mo. 1969).

15. *Id.* at 498. *See also* Rieke v. Brodof, 501 S.W.2d 66 (Mo. App., D. St. L. 1973); Holt v. Myers, 494 S.W.2d 430 (Mo. App., D. St. L. 1973).

16. 239 Ore. 429, 397 P.2d 529 (1964).

rule was "well-settled" in American case law.[17]

From practically the moment of its inception, the general rule denying recovery has been the subject of severe criticism from scholars,[18] textwriters[19] and judges.[20] Most authorities have been quick to point out that denial of recovery in such circumstances is a violation of the "both ways test"[21] of tort law. American courts have generally adhered to the view that one is not liable for the negligent torts of his spouse or child.[22] However, the same courts have held a spouse or parent accountable for the contributory negligence of a child or the other spouse.[23]

Critics of the general rule frequently draw an analogy between a plaintiff's interest in his spouse or child and his interest in his property. If a plaintiff sued to recover damages to his automobile incurred in a collision with a third party while the plaintiff's minor child was operating the automobile, the minor child's contributory negligence, if not the sole proximate cause of the damage, would not bar the plaintiff's recovery against a negligent third party.[24] Nevertheless, under the same circumstances, the general rule would bar recovery by the plaintiff for collateral damages suffered by him as a result of injury to his minor child. Although the plaintiff suffers a definite financial loss in both interests under identical circumstances, the general rule allows him compensation only for the damage to his automobile.

The derivative action theory appears, at least to one authority,[25] to be a timely invention employed by the court to reach a result

17. *Id.* at 434-36, 397 P.2d at 531-32.

18. Gregory, *The Contributory Negligence of Plaintiff's Wife or Child in an Action for Loss of Services, Etc.*, 2 U. CHI. L. REV. 173, 180-93 (1935); James, *Imputed Contributory Negligence*, 14 LA. L. REV. 340, 354-60 (1954).

19. 1 F. HARPER & F. JAMES, THE LAW OF TORTS, §§ 8.8, 8.9 (1956); W. PROSSER, LAW OF TORTS § 125 (4th ed. 1971).

20. *See* the dissenting opinion of Justice O'Connell in Ross v. Cuthbert, 239 Ore. 429, 397 P.2d 529 (1964).

21. Gregory, *The Contributory Negligence of Plaintiff's Wife or Child in an Action for Loss of Services, Etc.*, 2 U. CHI. L. REV. 173, 180 (1935) (vicarious or imputed liability has to work both ways or not at all).

22. W. PROSSER, LAW OF TORTS § 123 (4th ed. 1971).

23. Gregory, *The Contributory Negligence of Plaintiff's Wife or Child in an Action for Loss of Services, Etc.*, 2 U. CHI. L. REV. 173, 181 (1935).

24. Emery v. Frateschi, 161 Me., 218 211 A.2d 578 (1965); *see* James, *Imputed Contributory Negligence*, 14 LA. L. REV. 340, 355 (1954). Some courts have considered the parent's interest in the services of his child and freedom from medical expenses as analogous to a property interest. Frazier v. Georgia R.R. & Banking Co., 101 Ga. 70, 75, 28 S.E. 684, 686 (1897); Tidd v. Skinner, 225 N.Y. 422, 433, 122 N.E. 247, 251 (1919).

25. Gregory, *The Contributory Negligence of Plaintiff's Wife or Child in an Action for Loss of Services, Etc.*, 2 U. CHI. L. REV. 173, 181 (1935).

believed to be necessary. The basis of the derivative action rationale is that a cause of action found in one party originating from injury to another party is derived from the injured party and is therefore subject to any defenses which preclude recovery by the injured party. However, simply because an action is closely related to a person or thing, it does not necessarily follow that the action is derived from that person and dependent on that person's ability to recover.[26]

The assignment rationale has been criticized on the ground that an injured party cannot assign to another a right of action that never did belong to the injured party. From the initial moment of injury, the law gives to the spouse or parent an independent cause of action which the other spouse or child could never "sue on, or destroy by settlement or judgment, or assign."[27]

Although the general rule has for some time been the subject of criticism,[28] it has been consistently followed by American courts.[29] The Supreme Court of Iowa in *Handeland*, however, after mechanically examining each of the four basic rationales for the rule, displayed little hesitancy in rejecting the rule. Plaintiff's claim in

26. An action for the injury of a horse is obviously closely related to the horse and originates from the horse's injuries, but one could hardly say that the action is a derivative one, being derived from the horse. *Id.* at 183. Another valid point here is that the action for the seduction of one's minor daughter can be said to be derivative in the sense of *Dudley*, yet the consent of the daughter will not bar the recovery of the parent. W. PROSSER, LAW OF TORTS § 124 (4th ed. 1971).

27. James, *Imputed Contributory Negligence*, 14 LA. L. REV. 340, 355 (1954). One leading textbook, in a statement often quoted, but never followed until the *Handeland* case, sums up the "certain illogical aspects" of the general rule:

> If there are different interests invaded by different wrongs, it might be thought irrelevant to the husband's cause of action that the wife's has been barred by her contributory negligence. If we are to accept the principle of the Restatement of Torts, negligence is not "imputed" to a plaintiff unless his relationship to the person whose negligence is involved is such as to make him liable for that person's negligence if it resulted in injury to a third person. Here, the husband is not in modern law liable for his wife's torts and accordingly should not be barred from recovery against a third person by her negligence. To assign, as a reason, the derivative character of his action is really begging the question since it does little more than to state the result in different language. And to state that there is but one cause of action which is "divided" between the wife and husband is not accurate since the nature of the husband's interest is different and distinct from the wife's.

1 F. HARPER & F. JAMES, THE LAW OF TORTS § 8.9, at 640 (1956).

28. A Canadian case as early as 1933 refused to follow the general rule. Wasney v. Jurazsky, 1 D.L.R. 616 (1933).

29. Pioneer Constr. Co. v. Bergeron, 170 Colo. 474, 462 P.2d 589 (1969); Schaffner v. Smith, 158 Colo. 387, 407 P.2d 23 (1965); Broitman v. Kohn, 16 Mich. App. 400, 168 N.W.2d 311 (1969); Barash v. KLM Royal Dutch Airlines, 315 F. Supp. 389 (E.D.N.Y. 1970); McNally v. Addis, 317 N.Y.S.2d 157, 65 Misc. 2d 204 (Sup. Ct. 1970).

Handeland, although previously recognized as a claim at common law, was statutory in Iowa.[30] The derivative rationale, as applied to this statutory claim, had previously been rejected by the Supreme Court of Iowa in *Irlbeck v. Pomeroy*.[31] In *Irlbeck* the court distinguished the Rule 8 claim for a truly derivative action such as wrongful death, which is brought to redress a wrong done to another rather than to the claimant. Under Rule 8 the parent brings a claim for a legal wrong done to himself, not to his child.[32] The imputed negligence theory had been expressly condemned in *McMartin v. Saemish*,[33] where the court described *Chicago, Burlington & Quincy Railroad v. Honey*[34] as "an interesting discussion of the old law."[35] Earlier Iowa cases had rejected the family relationship itself as a basis for imputing contributory negligence.[36] The court in *Handeland* explicitly rejected the rationale of the *Honey* case stating that it "rest[ed] on an archiac and discredited view of familial responsibility."[37] The assignment rationale was described in *Handeland* as a "convenient legal fiction without historical validity."[38] Furthermore, the court noted that the Rule 8 claim was an independent action in no way based on an assignment rationale. The *Handeland* court believed it was under no obligation to follow a rule simply because it was generally accepted in other jurisdictions. "When common law principles are no longer supportable in reason they are no longer supportable in fact."[39] Finding no supporting reasons for the general rule, the court rejected the rule in fact and held that a child's contributory negligence is not a defense to a parental claim under Rule 8.[40]

The effect of the Iowa decision on the law of other states may be limited. *Handeland* was a case of first impression, allowing the court considerable freedom in reaching its result. Furthermore, be-

30. IOWA R. CIV. P. 8.

31. 210 N.W.2d 831, 833 (Iowa 1973); *see also* Wardlow v. City of Keokuk, 190 N.W.2d 439, 443 (Iowa 1971).

32. Irlbeck v. Pomeroy, 210 N.W.2d 831, 833 (Iowa 1973).

33. 254 Iowa 45, 116 N.W.2d 491 (1962).

34. *See* note 7 and accompanying text *supra*.

35. McMartin v. Saemisch, 254 Iowa 45, 50, 116 N.W.2d 491, 494 (1962).

36. Wymore v. Mahaska County, 78 Iowa 396, 43 N.W. 264 (1889) (parent's negligence not imputed to his child); Watson v. Wabash, St. L. & P. Ry., 66 Iowa 164, 23 N.W. 380 (1885) (child's negligence not imputed to his parent).

37. 216 N.W.2d at 576 (Iowa 1974).

38. *Id.* at 577. The court cited two recent Iowa cases in explaining its view of the assignment rationale as applied to Rule 8. Irlbeck v. Pomery, 210 N.W.2d 831 (Iowa 1973); Wardlow v. City of Keokuk, 190 N.W.2d 439 (Iowa 1971).

39. Handeland v. Brown, 216 N.W.2d 574, 577 (Iowa 1974).

40. *Id.* at 579.

cause the general rule is well established in most states, few cases are likely to be appealed challenging the validity of the rule. Thus, if change is to come in this area it will likely be the result of legislative rather than judicial action. The fact that the cause of action was based on Rule 8[41] may further limit the application of *Handeland* to those states having statutory causes of action similar to Rule 8. However, the court's reasoning in *Handeland* may be applied to the similar common law cause of action with no logical difficulty. To the extent that *Handeland* is based solely on Rule 8, it applies only to a parental claim for tortious injury to a minor child, and not to the other half of the general rule concerning a spouse's action for tortious injury to the other spouse. Nevertheless, the court's reasoning is applicable to a spouse's consortium and medical expense actions under a similar factual situation.

In holding that a child's contributory negligence is not, *per se*, a defense to a parental claim for loss of services, the Supreme Court of Iowa has chosen a result which is "logical" rather than one which other courts have termed "just."[42] The usefulness of *Handeland* in other jurisdictions may be limited by the strength of the general rule denying recovery, but the case does serve as some basis for an assertion of a previously unaccepted viewpoint.

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41. IOWA R. CIV. P. 8. Some of the cases cited in the opinion in rejecting the different rationales of the general rule were concerned specifically with Rule 8. *See* Irlbeck v. Pomeroy, 210 N.W.2d 831 (Iowa 1973); Wardlow v. City of Keokuk, 190 N.W.2d 439 (Iowa 1971).

42. The *Handeland* case was a five to four decision. Such decisions, as most judicial observers are quick to note, are often prone to change.